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

HC 513 SESSION 2016-17 19 JULY 2016

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National Audit Office

HM Treasury, UK Financial Investments, UK Asset Resolution

The £13 billion sale of former Northern Rock assets

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

15 July 2016

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This report considers whether the sale of £13.3 billion of loans and mortgages out of Northern Rock's legacy assets provided value for money in the context of the government's objective to reduce its balance sheet.

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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 million[4] 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.

Part One

Introduction

1.1 This section provides background information on Northern Rock (NR) and the assets that were sold. It also sets out the context of the transaction, including the objectives of the parties involved, and implications of the transaction for public finances.

Background on Northern Rock

1.2 NR went from building society to listed bank in 1997. It grew to become a major UK mortgage lender; in the first half of 2007 its net mortgage lending represented around one-fifth of the UK total. NR's growth relied heavily on wholesale funding from other banks and securitisation. Securitisation is a financial process that raises funds through bundling mortgages together and selling their cash flows to investors via a special purpose vehicle.

1.3 From 2001 NR securitised its residential mortgages through a vehicle called Granite. In September 2007, with the onset of the financial crisis, demand for securitised assets fell substantially and the wholesale funding market collapsed. As a result, NR was forced to ask the Bank of England for support. Subsequently NR's customers started to withdraw their savings, resulting in HM Treasury guaranteeing the deposits and other liabilities of the bank. In February 2008, HM Treasury concluded that the company should be brought into public ownership. We reported on these events in *The nationalisation of Northern Rock*.[5]

1.4 Following nationalisation, HM Treasury had originally planned for NR to run down its mortgage assets to repay government support by 2011 and then enter a period of growth in preparation for a return to the private sector. However, following higher than expected losses, HM Treasury reviewed other options. In January 2010, it decided to split NR into two new businesses:

- **Northern Rock plc**, a retail bank that could be returned to private sector ownership; and
- **Northern Rock (Asset Management) plc (NRAM)**, to wind down outstanding loans, mortgages and liabilities.

5 Comptroller and Auditor General, *The nationalisation of Northern Rock*, Session 2008-09, HC 298, National Audit Office, March 2009.

1.5 Northern Rock plc was sold to Virgin Money at the end of 2011. We reported on this in *The creation and sale of Northern Rock plc*.[6] The majority of assets and liabilities remained in public ownership within NRAM. Appendix Three summarises the key events in the government's involvement in NR.

1.6 Since 2010, NRAM has been owned by UK Asset Resolution Limited (UKAR), which also owns Bradford & Bingley. Over the past six years UKAR has started to repay the support provided by the taxpayer. HM Treasury has calculated that with UKAR expected to repay the remainder of its outstanding loans in full, the current book value of UKAR plus the payments received to date implies the taxpayer will recover £11 billion more in cash than was put in. The part of this which can be attributed to Northern Rock is around £5 billion. However, these figures exclude the interest costs on the government debt issued to rescue these banks and figures relating to the Financial Service Compensation Scheme (**Figure 1**).

Figure 1

Gross and net cash flows of intervention in UKAR and Northern Rock

	Cash outlays (£bn)	Principal repayments (£bn)	Interest and other fees received (£bn)	Outstanding payments (£bn)	Market value (£bn)	Implied balance (excluding government interest costs) (£bn)
UKAR	-40.8	26.9	4.0	13.4	7.6	11.2
Northern Rock	-28.8	19.9	1.7	8.5	4.2	5.4

Notes

1 All figures relate to the position as at December 2015 with the exception of the market value which is the book value of equity as at September 2015.

2 The Northern Rock figures are a subset of the UKAR figures.

3 The figures for UKAR do not include the Financial Services Compensation Scheme intervention. The total cash outlays from this intervention amount to £20.9 billion; £4.5 billion of principal has been repaid (plus £2.7 billion in interest and fees), leaving outstanding payments of £15.7 billion.

4 These figures exclude the interest costs on the government debt issued to fund the intervention. At the end of December 2015 the total interest costs for all the financial interventions (which includes more than £85 billion cash outlays for the intervention in Lloyds and RBS) was estimated at £24.4 billion.

5 The outstanding payments column does not include future interest payments.

6 Totals may not sum due to rounding.

Source: Office for Budget Responsibility, *Economic and fiscal outlook*, March 2016, Table 4.4; HM Treasury analysis

6 Comptroller and Auditor General, *The creation and sale of Northern Rock plc*, Session 2012-13, HC 20, National Audit Office, May 2012.

UKAR and UKFI objectives

1.7 UK Financial Investments Limited (UKFI), which manages the government's shareholding in UKAR, has an over-arching objective to "protect and create value for the taxpayer, while paying due regard to financial stability and acting in a way that promotes competition".[7] The unpublished UKFI-UKAR framework agreement notes that "UKAR's board recognises UKFI's mandate to develop and execute an orderly and active disposal of HM Treasury's investment in financial institutions […] and will work collaboratively with UKFI to develop strategic options relating to the disposal of the company, its business or its assets". UKAR's mission, agreed in 2010, is "to maximise value for the taxpayer". As part of this, it has a number of different objectives, one of which is to reduce, protect and optimise the balance sheet.

1.8 In 2013, UKAR was reclassified as a central government public sector body. The reclassification made HM Treasury's permanent secretary responsible for overseeing UKAR. The chief executive of UKAR became an accounting officer (AO) directly accountable to Parliament. The reclassification also resulted in UKAR's liabilities being included within measures of government debt.

1.9 Given these changes, HM Treasury, UKFI and UKAR carried out a strategic review of UKAR beginning in February 2014. It concluded that UKAR's main objective should be changed to: "reduce its balance sheet as swiftly as possible by selling assets, demonstrating value for money on a case-by-case basis". Ministers and officials agreed the change in UKAR's focus. This was noted at UKAR's board in September 2014, but the board did not consider a formal change to its objectives was required.

1.10 Under European Union State Aid rules, UKAR is not allowed to issue new mortgages or take on other new business. Its balance sheet is, therefore, reducing as customers repay their loans or re-mortgage with other providers. Between October 2010 and March 2014, UKAR's assets reduced by £40.9 billion (a rate of £1 billion a month). Nearly all of this occurred through either a natural run-down or impairment of its assets. Between April 2014 and May 2016, UKAR's assets fell by £32.6 billion (a rate of £1.25 billion a month) to £42.3 billion. Around half of this reduction since April 2014 has come from sales (**Figure 2** overleaf).[8]

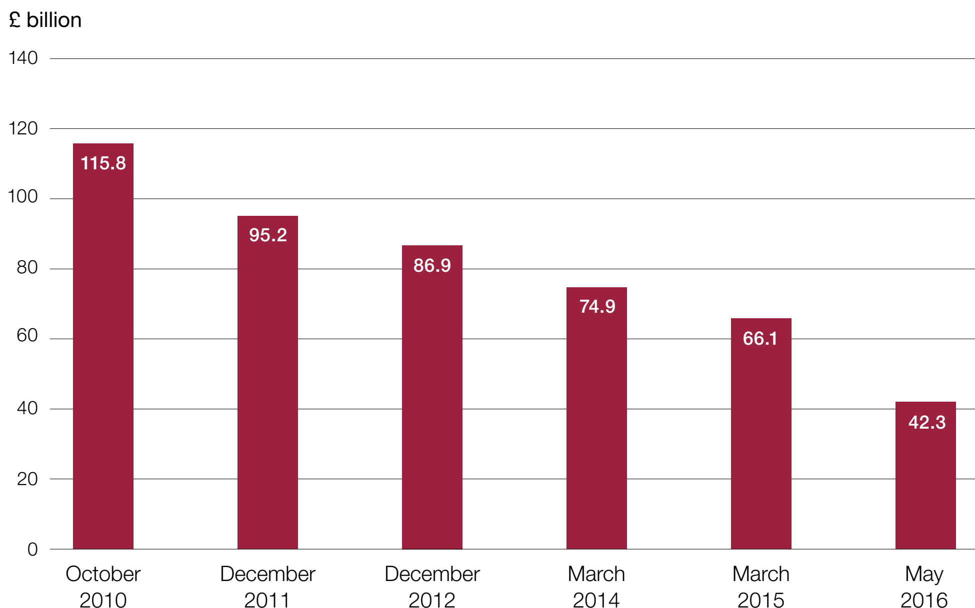
7 UKFI, *Framework Document,* March 2014 (between HM Treasury and UKFI). Available at: www.ukfi.co.uk/releases/UKFI%20Framework%20Document-Revised%20October%202014.pdf

8 This includes £13.3 billion from this sale and £2.7 billion for mortgages sold in November 2014.

Figure 2

UKAR's balance sheet assets

UKAR's balance sheet has reduced by 63% between October 2010 and May 2016



Source: UK Asset Resolution Limited *Annual Report and Accounts 2014-15* and UK Asset Resolution Limited "UK Asset Resolution announces successful sale of £13 billion assets", 13 November 2015. Press release, available at: www.ukar.co.uk/media-centre/press-releases/2015/13-11-2015

1.11 Owing to the fast natural reduction of assets, and the related reduction in their customer base, UKAR and UKFI were concerned that staff would be more likely to leave the business, creating a risk to servicing the remaining loans. They were also concerned that, as the assets reduced, the business would become too small to justify the scale of operation required to provide an effective service. In 2013 UKAR began to evaluate options for outsourcing or selling its mortgage servicing operation (Project Phoenix). Transferring the operating platform to another provider also made asset sales more straightforward, as buyers could continue to use the same servicing arrangements should they wish.

1.12 UKAR has a number of documents to inform its strategy, including its 10-year plan which charts the run-down of the asset base, and submissions to its board on areas such as balance sheet optimisation and asset disposal options. There is no single document that draws this strategy together. For example, it was only in late 2015 that the 10-year plan included scenarios for future asset sales. Those documents we reviewed collectively offer the components of a strategy, but focus primarily on short- to medium-term options and do not consider fully what will happen to the assets remaining following disposals. UKAR does not feel that developing a detailed strategy for final wind-down would be appropriate given that it is likely to be holding assets for a number of years and the exact speed of balance sheet wind-down is uncertain.

Sale of £13 billion asset portfolio

1.13 In June 2014 at the start of the sale process for a £2.7 billion sale of mortgage assets (Project Slate), UKAR was approached by buyers interested in acquiring the Granite special purpose vehicle (Granite). This, combined with improving market conditions, gave UKAR confidence to explore, and ultimately launch, an asset sale that included Granite.

1.14 Nearly all (more than 90% by value) of the £13 billion assets UKAR decided to sell were mortgages within Granite. Granite was well known in the financial markets, and the mortgages were attractive to investors as they offered a good yield (85% of the mortgages pay more than 4.5% interest). However, they also had a higher loan-to-value (72.4%) and arrears ratio (3% were in arrears by more than three months) than the market average.

1.15 Alongside the Granite mortgages, there were more than £1 billion of other assets in the sale. These included £0.6 billion of unsecured loans associated with mortgages in Granite, and £0.6 billion of other mortgages. It was forecast that government debt would be reduced by £13 billion but the taxpayer would not receive £13 billion in cash – as Granite's liabilities were also being transferred, the buyer would take on these liabilities, or refinance them, leaving a net amount of between £5 billion and £6 billion to repay the taxpayer (**Figure 3** overleaf and Figure 12 on page 30).

Impact of the transaction on public finances

1.16 In the March 2015 Budget, the Office for Budget Responsibility (OBR) forecast that the proceeds from the proposed UKAR sale meant that public sector net debt (PSND) as a percentage of GDP was forecast to fall between 2014-15 and 2015-16. If the expected sale proceeds, which amounted to around 0.6% of GDP, had not been included the debt to GDP ratio would have been forecast to rise in 2015-16.[9] The inclusion of the planned sale in the forecast meant that, at the Budget, HM Treasury was able to announce it was on course to meet its fiscal target to see debt falling as a percentage of GDP in 2015-16.[10]

1.17 As with any policy costing, HM Treasury brought evidence on the sale to the OBR in advance of the Budget in order to determine the level of detail that would be necessary for the OBR to include it in the forecast. HM Treasury wanted the sale proceeds to be included in the forecast, but did not want to disclose too much detail as it believed this could be detrimental to the price achieved in any transaction. The OBR required a more detailed commitment to be made public in order for it to be included. At the budget the Chancellor said UKAR was planning to sell £13 billion of assets and UKAR publicly announced that it would be exploring options for sales, including around Granite. The OBR was informed of these planned statements in advance and judged them to be sufficiently detailed to include the proceeds of the sale in its forecast.

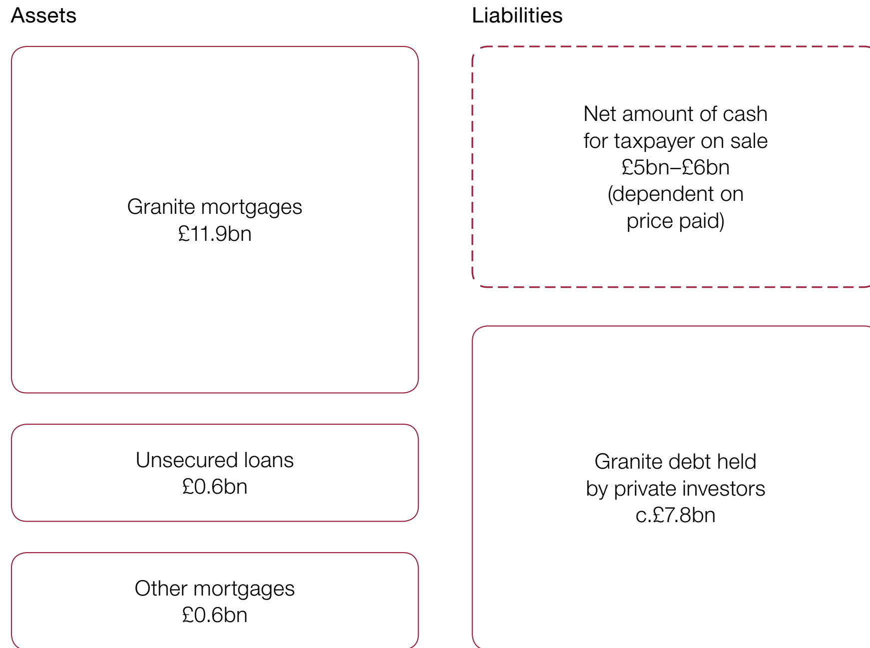
9 In March 2015 the OBR forecast the sale would raise £11 billion, approximately 0.6% of GDP. The PSND to GDP ratio was forecast to fall by 0.2% between 2014-15 and 2015-16. OBR, *Economic and fiscal outlook*s, March 2015, paragraph 1.12, paragraphs 5.12 and 5.13, Chart 5.2, Table 4.38.

10 With hindsight, it can now be seen that the ratio of debt to GDP did not fall in 2015-16. This was because GDP growth was lower than expected, and was not related to the asset sale.

Figure 3

Assets and liabilities to be sold in sale (simplified balance sheet)

The sale of the £13 billion assets portfolio removed around £8 billion of liabilities from the government balance sheet and provided a net amount of cash of between £5 billion and £6 billion



Notes

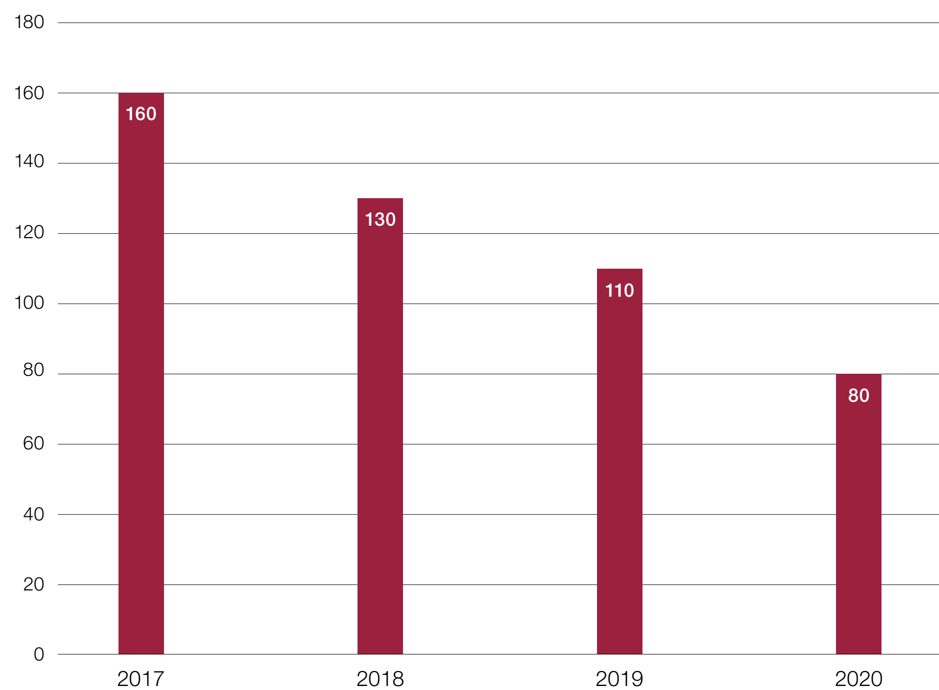
1 All figures as at June 2015.

2 The sale would reduce government debt by approximately £13 billion. Granite's debts held by private investors (£7.8 billion) would be removed from the government balance sheet. HM Treasury would receive between £5 billion and £6 billion in cash, depending on the value that the buyer attributed to the equity.

Source: Information memorandum, National Audit Office analysis

1.18 Although selling the assets reduces PSND in the short term, it increases the annual deficit. This is because the assets sold were yielding more than the government cost of borrowing. UKFI analysis for the accounting officer and ministers forecast that the sale meant the deficit would increase by an average of £120 million a year over the next four years (**Figure 4**).

Figure 4
Forecast increase in annual deficit due to sale



Source: UK Financial Investments Limited ministerial submission, February 2015

1.19 HM Treasury's value-for-money framework for UKAR noted that if the assets were valued by discounting at the government discount rate, or prevailing gilt rates, it would be likely to lead to a 'hold' recommendation for most of UKAR assets. The framework stated that the difference between the higher "value to the government" and the lower market value of the assets was an accepted cost of achieving the policy objective of exiting the investment in UKAR. As the policy decision had been made to sell the assets, valuations were based on what a market participant, with a higher cost of capital than the government, would be willing to bid. Nevertheless, submissions to HM Treasury's accounting officer noted that the initial large reduction in debt from the sale would eventually be outweighed by the gains from holding the assets. UKFI calculated that within ten years more debt would be paid off if the assets were held by government rather than sold. However, the potential for increased government debt repayment over the long term through holding the assets to maturity was not quantified as no 'hold' valuation was calculated.

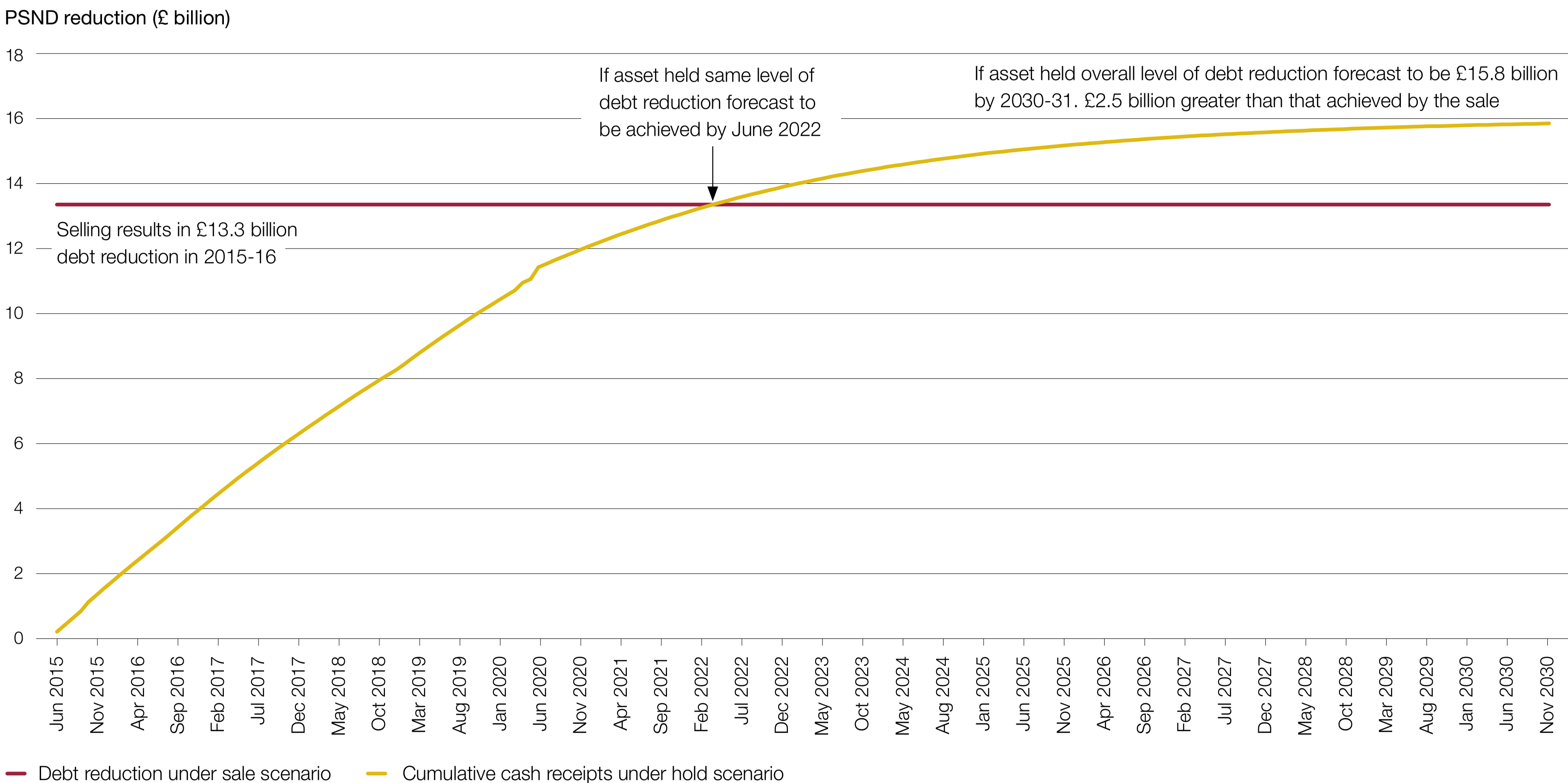
1.20 Using UKAR's estimate of cash flows for the assets sold (which include estimates for defaults and repossessions), it is possible to calculate the amount of extra debt reduction over the long term by keeping the assets and receiving the cash rather than selling (**Figure 5**). UKAR forecast that the total future undiscounted cash flows from the assets amounted to around £17 billion. Using the government yield curve to discount these cash flows shows that the government could have achieved the same £13.3 billion level of debt reduction (realised by the sale) within seven years. Within 15 years, the debt could have been reduced by £15.8 billion overall (£2.5 billion more than from selling) (**Figure 6** on page 20). These future cash flows, and therefore the exact benefit of holding the assets, are uncertain. A downturn in the economy or housing market would affect them. By selling, HM Treasury reduced its exposure. However, UKAR's previous stress-testing (which modelled the impact of significant economic shocks) showed that the company and NRAM would continue to be profitable in the long run, albeit total net profit of NRAM over the next ten years would be around 15%–20% lower than under the base case.[11]

11 One of the stress test scenarios, conducted in 2014, modelled the impact of a two-year recession and the other modelled the impact of interest rates rising to 7%.

Figure 5

Potential debt reduction from holding rather than selling assets

Future cash flows from holding assets to maturity could have reduced government debt by more than £15 billion



Notes

1 Cash received reduces public sector net debt by an equivalent amount.

2 The cash flows forecast to be generated by the assets have been discounted by the government yield curve to provide a net present value.

3 The forecast for the underlying cash flows and the discount rates used have been taken from UKAR's valuation prepared in 2015.

4 The debt reduction calculation assumes that the Granite liabilities would have been refinanced with cheaper government funding as recommended by HM Treasury officials in 2014. If the government had not made this funding available, the overall debt reduction would have been around £0.2 billion lower.

Source: UK Asset Resolution Limited, National Audit Office analysis

Figure 6

Forecast change in government debt and deficit due to the sale

Sale is due to reduce government debt in the short term but increase it in the long term

	In-year change	By 2020	By 2030
Net debt position (PSND)	Reduce (c.£13.3 billion)	Reduce (c.£2 billion)	Increase (c.£2.5 billion)
Annual deficit (PSNB)	Increase (c.£0.2 billion)	Increase (c.£0.1 billion)	Slight increase

Notes

1 The forecast increase in the annual deficit by 2030 is caused by the cost of interest on the increased government debt.

2 PSND stands for Public Sector Net Debt.

3 PSNB stands for Public Sector Net Borrowing.

Source: UK Financial Investments, UK Asset Resolution, National Audit Office analysis

Part Two

Preparation

2.1 This part reviews the options the government considered and how it prepared for the sale.

Appointment of advisers

2.2 During summer 2014, UK Asset Resolution Limited (UKAR) worked on a plan to separate out its operating business ('OpCo'), which manages customer relationships and loan administration, in order to sell or outsource it (see paragraphs 1.11 and 1.12). Alongside this, it considered options for selling other assets.

2.3 In September 2014, UKAR identified nine investment banks as potential advisers. It asked three to submit proposals in relation to OpCo and a possible asset sale. Only two had practical experience with securitisations. After a tender process, Credit Suisse (CS) was appointed. The board noted that CS had extensive knowledge of UKAR's business as it had advised the company on a previous transaction. It had also provided pro bono advice on UKAR's strategy development earlier in the year. UK Financial Investments Limited (UKFI) considered CS a good appointment as it was experienced in mortgage securitisations. UKFI appointed its own financial adviser, Moelis, to provide a view independent of UKAR and CS.

Options considered

2.4 In November 2014, UKAR's board discussed possible sale options. These included the sale of the Granite securitisation vehicle (Granite), as both UKAR and UKFI had received market interest in Granite.

2.5 CS provisionally concluded that a sale including Granite was likely to be more difficult than a more straightforward sale of unencumbered assets. It found that the large sales (which included Granite) scored lowest in terms of taxpayer value, but highest in terms of balance sheet reduction (**Figure 7** overleaf). CS did not quantify the value for taxpayers at this stage. Given the inbound interest and potential appetite for Granite and as balance sheet reduction was a priority, all parties focused on establishing whether a sale of Granite was a realistic possibility and, if such a sale were to be launched, whether it would likely attract sufficient demand to be value for money.

Figure 7

Banking adviser's initial assessment of sale options

The initial assessment prior to market testing considered that a sale including Granite had a high ranking for reducing the balance sheet but a low ranking for taxpayer value

	Unencumbered assets[1]	Unencumbered assets and covered bonds[2]	NRAM[3]	Granite[4]
Feasibility	Readily identifiable buyer universe	Readily identifiable buyer universe	Universe of potential buyers limited due to magnitude of funding requirement Technical issues in relation to change of ownership May be limited to large banks or consortia	Universe of potential buyers limited due to magnitude of funding requirement Technical issues in relation to transferring the Granite platform May be limited to large banks or consortia
Taxpayer value	Market for asset sales currently robust However, a comparison of market to intrinsic value is required, particularly for more challenging assets	Market for asset sales currently robust Price required to unwind covered bonds uncertain; cost–benefit analysis required	Value dependent in part on availability of seller financing and ability to resolve structure specific issues	Value dependent in part on availability of seller financing and ability to resolve structure specific issues Reverse inquiry has been received
Speed of balance sheet reduction	Smallest quantum of assets sold	Unwind of covered bond increases available assets, although market imposes some size constraints	Largest quantum of assets sold, but will depend on provision of seller financing and requires significant preparation time	Largest quantum of assets sold enables acceleration of debt repayment but requires longer preparation time

Increasing favourability

Notes

1 Unencumbered assets. This would have been structured as a whole loan sale. The asset perimeter was a subset of NRAM assets excluding those collateralising the NRAM covered bonds or Granite.

2 Unencumbered assets and covered bonds. This would have been structured as a whole loan sale. The asset perimeter was a subset of NRAM assets excluding those collateralising Granite.

3 NRAM (Northern Rock (Asset Management) plc). This would have been structured as a share sale. The asset perimeter was the whole of NRAM plc, which included Granite.

4 Granite. This would have been the sale of the Granite structure. The asset perimeter was the mortgage loans securitised in Granite.

Source: Credit Suisse, Project Phoenix, Process Considerations, 25 November 2014

Structuring the sale

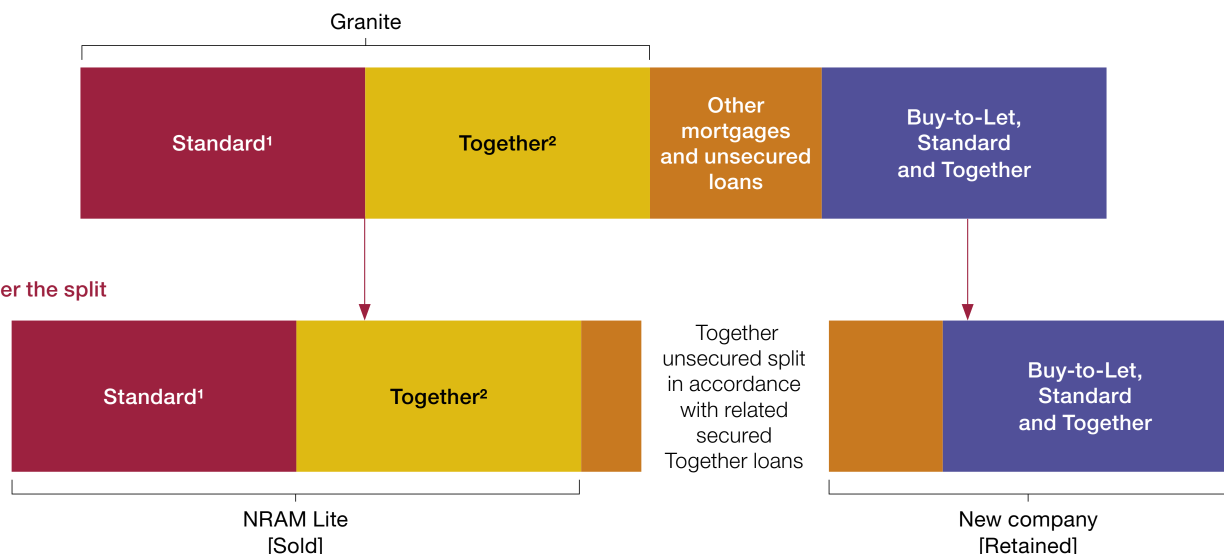
2.6 Following legal advice, UKAR and CS worked on resolving a number of technical difficulties in selling Granite. For example, transferring the ownership of Granite outside of NRAM could not be done without the necessary consent of debt holders in Granite. Obtaining this would have been time-consuming and costly and may not have been deliverable. Also, some of the customers with mortgages within Granite had an unsecured 'Together' loan. These customers make one payment each month that covers the mortgage and the loan. UKAR considered that separating these loans from the mortgages in Granite would have been technically very difficult and would also not be in the customers' interest.

2.7 The solution was to sell NRAM, which included the ownership rights of Granite, and transfer other assets into another new company, 'StayCo'. However, to transfer these assets, UKAR needed to buy out around £3 billion of covered bonds (Project Cheviot).[12] We have not assessed the value for money on Project Cheviot, but UKFI board papers show that the financial impact of the debt buy-back was broadly neutral for the taxpayer. **Figure 8** shows the split of NRAM in preparation for the sale.

Figure 8

Split of NRAM in preparation for sale

NRAM assets that were not for sale were moved to a new company



Notes

1 Standard is a normal mortgage product secured against a property.

2 Together is a mortgage product with a component secured against property and an unsecured loan.

Source: National Audit Office

12 Covered bonds are debt securities backed by cash flows from mortgages. These bonds needed to be removed in order to transfer assets out of NRAM into StayCo. UKAR used funds received from selling £2.7 billion of mortgages and additional funds from HM Treasury to buy back the covered bonds.

Market testing and timing

2.8 In January 2015, UKAR and its banking adviser confidentially approached five potential buyers to test the most appropriate structure and level of demand for selling Granite. The main two options were:

- **Sell Granite intact** – the asset portfolio would be sold together with the securitised debt in Granite as well as other liabilities. Buyers would have financing requirements of around £7 billion.
- **Unwind Granite** – UKAR would buy out the securitised debt in Granite and sell the assets 'unencumbered'. Buyers would have higher financing requirements of around £13 billion, assuming a single sale.

2.9 The market testing showed that there was interest in both structures. In particular, private equity buyers tended to prefer to keep the Granite debt financing intact as the debt already contained in the structure meant that they would not need to raise as much finance to purchase the assets. Feedback from the market testing also showed that the size of the asset sale of £13 billion was considered ambitious by investors. Some potential bidders also said that certain assets were outside their risk appetite.

2.10 As potential bidders expressed interest in both of the different structures, UKAR decided to keep Granite intact to reduce the financing requirements and ensure private equity buyers remained within the pool of potential bidders. However, bidders that wanted to unwind the structure would also be able to make bids on this basis. UKAR felt that a benefit of keeping Granite intact was that bidders would not be able to 'cherry pick' assets.

2.11 Bidders looked to form consortia as the asset mix was outside some bidders' risk appetite, and for some the scale was unmanageable without support. This, combined with the complexity of the Granite structure, may have reduced the number of initial bids. We acknowledge that competitive tension was maintained, however, the composition by bidder type displayed high private equity and low retail bank participation.[13]

2.12 UKAR considered the timing of this asset sale and concluded that there was a strong market demand. In late 2014 UKAR had successfully sold £2.7 billion of mortgages in a competitive process that showed there was significant interest in UKAR's assets. In addition, investor appetite for the securitisation market had improved since 2013. This was evidenced by the reducing cost of debt for mortgage-backed securities and an increase in issuance.

2.13 UKAR planned this sale in parallel with the sale of OpCo. The bidders were given the option of keeping the servicing of the loans with OpCo once it was sold, or transferring it to another provider. It was in UKAR's interest to encourage the first option as, if the buyer of the assets did not want to use OpCo to service its loans, the operating company would lose significant revenue which would affect its value.

13 There were 63 expressions of interest, followed by six first round bids.

Business case

2.14 UKAR sought all the necessary approvals from UKFI and HM Treasury to sell the assets quickly and take advantage of good market conditions. HM Treasury did not require UKAR or UKFI to produce a business case on this or previous transactions. According to UKAR and UKFI, preparing a formal business case would have taken up valuable time and resources and limited their ability to react quickly to changes in the transaction process.

2.15 A lack of a formal business case is, however, inconsistent with HM Treasury's expectations of other government departments and organisations. For example, in preparation for the sale of the government's stake in Eurostar, the Shareholder Executive prepared a formal business case and also asked for an internal gateway review of the sale process. UKAR received all relevant approvals from HM Treasury, but it did not follow all parts described in HM Treasury's summary of UKAR's value-for-money framework.[14] For example, UKAR did not value the different sales options before deciding on the sale structure as part of the prioritisation stage. However, HM Treasury's review made it clear that there was not and should not be "a single deterministic approach" to value for money.

Revised adviser fees

2.16 The transaction fee for CS was originally agreed at £2 million. However, once the complexity and size of transaction became clear, UKAR agreed to increase this success fee to £4.5 million. According to UKAR, re-running the procurement would have compromised the transaction and not necessarily achieved a lower fee.

2.17 The overall fees for the transaction amounted to £15.5 million, of which £2.5 million was related to Project Cheviot (**Figure 9** overleaf). The transaction resulted in the executive directors achieving their medium-term incentive target for reducing the balance sheet, one year early. The total cost of these bonuses was £0.4 million. The cost was disclosed in UKAR's 2015-16 accounts but it will not be paid until 2017 in line with the original expected date of payment.

2.18 CS's contract with UKAR also allowed it to provide financing for potential bidders for the asset portfolio. In previous transactions, UKAR had not allowed its adviser to do this in case it caused a conflict of interest. For example, as well as receiving a fee for advice, a bank that also financed bidders would stand to gain if these bidders bought the assets. This could influence the objectivity of its advice on sale options. However, given the large amount of financing required for any potential bidder in this transaction, UKAR felt that allowing CS to participate would increase the amount of financing available to bidders and therefore reduce execution risk and provide better value overall. UKAR felt that a strict separation of CS's financing and advisory teams mitigated any potential conflict. UKFI's adviser, Moelis, was also asked to review CS's recommendations as an additional check to ensure that CS's advice was objective.

14 This is separate to, and should not be confused with, the Framework Agreement (see paragraph 1.7) – there are two stages in the value for money framework summary: prioritisation, and transaction specific analysis.

Figure 9
Advisers and costs

Granite advisers: costs incurred by UKAR/UKFI	
Financial adviser (Credit Suisse)	£5.4 million
Legal adviser (Slaughter and May)	£5.0 million
KPMG – vendor due diligence and reverse due diligence	£0.6 million
Moelis – UKFI financial adviser	£2.0 million
Total	**£13.0 million**

Cheviot advisers: costs incurred by UKAR	
Financial advisers	£2.4 million
Legal adviser	£0.1 million
Total	**£2.5 million**

Notes

1 The Credit Suisse fee of £5.4 million includes a transaction fee of £4.5 million and a monthly retainer which amounted to £0.9 million.

2 Moelis was also engaged in other work for UKFI over the period. The fees of £2 million also include this work and additional work to the end of the contract in November 2016.

Source: UK Asset Resolution Limited

Part Three

The sale process and proceeds

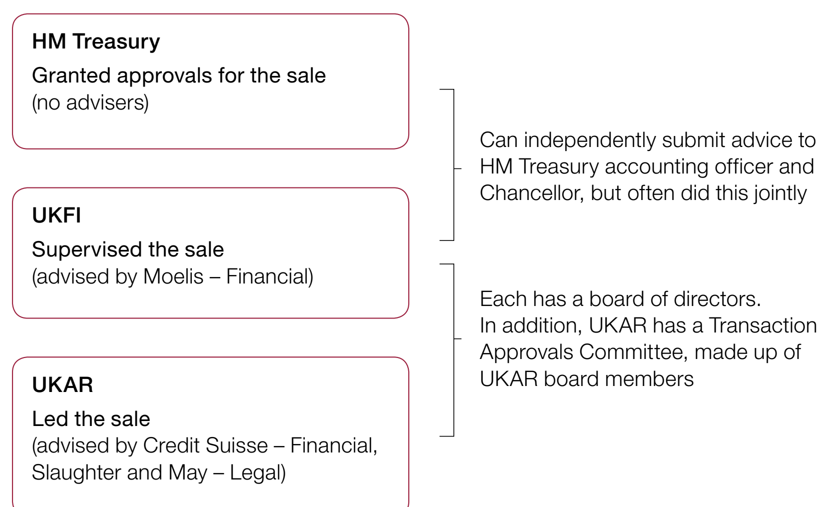
3.1 This part explains the governance and approval process of the transaction and reviews the sales process and proceeds, including customer protection considerations.

Governance and approval process

3.2 Three organisations are involved in significant sale decisions: UK Asset Resolution Limited (UKAR), UK Financial Investments Limited (UKFI) and HM Treasury (**Figure 10**). HM Treasury owns both UKFI and UKAR, which are set up as companies, with boards. Their boards approve all major asset sale transactions. UKAR's board may delegate responsibilities for carrying out asset sales to the Transaction Approvals Committee. This is a sub-committee of UKAR's board made up of UKAR's board directors which include a UKFI delegate.

Figure 10

The governance structure of the sale



Notes

1 The relationships between HM Treasury and UKFI, and UKFI and UKAR are each underpinned by a framework agreement.

2 This figure only shows UKAR's legal and financial advisers. UKAR had additional advisers (see Figure 9).

3 Additional committees were in place to manage other parts of UKAR's sale programme, such as the sale of the operational platform.

Source: National Audit Office

3.3 Together the parties set their value-for-money criteria for the sale. These included whether:

- the timing of the sale was correct, based on favourable market conditions (covered in Part Two of this report);
- the process created effective competition during the sale (Part Three); and
- the sale price was above government's valuation of the assets (Part Four).

3.4 The approvals process worked efficiently; for example, a preferred bidder was selected within a week of receiving the final bids. The three parties worked together well. On some approvals, UKFI and HM Treasury officials provided joint submissions to HM Treasury's accounting officer. All advice to the HM Treasury accounting officer was reviewed by and agreed with the UFKI and UKAR accounting officers. UKAR received all relevant approvals from HM Treasury (see paragraphs 2.14 and 2.15).

3.5 In the March 2015 Budget HM Treasury announced that UKAR would be selling £13 billion of assets. On the same day, UKFI's executive chairman wrote to the Chancellor setting out timing considerations.[15] He noted that market conditions were good and cited evidence that investors were attracted to UKAR's assets, including those within Granite.

3.6 The sale process, summarised in Appendix Four, formally started on 18 March 2015. UKAR announced the sale and, together with its adviser, started collecting expressions of interest from bidders. UKAR had decided on a standard two-round bidding process. This enabled it to: receive expressions of interest; elicit Round 1 bids from bidders; and shortlist bidders for further detailed discussion in Round 2.

3.7 Sixty-three parties expressed an interest. This resulted in six initial bids in June 2015. All bids were from either consortia or those seeking to build consortia. Five of the six bids were led by financial buyers, and one by a retail bank. A consortium including Credit Suisse Asset Management (CSAM) submitted the highest bid. This bid was also part debt financed by CS. After the bid was submitted CS considered that there was a perceived conflict as other bidders might consider that the CSAM bid received preferential financing terms from CS. CS therefore chose to withdraw its financing offer and CSAM subsequently decided to withdraw from the bidding process.[16] UKAR considered one bid not competitive and took four bidders through to Round 2.

3.8 The four Round 2 bidders were given additional information on Northern Rock (Asset Management) Plc (NRAM's) balance sheet and offered the opportunity to ask UKAR's deal team detailed questions. All four bidders told us that UKAR and CS managed the process well and responded promptly to the questions they raised. The retail bank told us that it felt the sale process could have been improved by providing better information, such as repayment plans for interest-only mortgage customers. However, UKAR did not hold some of this information.

15 Letter from Executive Chairman, UKFI, to the Chancellor of the Exchequer, 18 March 2015. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/413886/150318_-_UKAR_mortgage_assets.pdf

16 Credit Suisse Asset Management (CSAM) is a global asset management business siting within the Credit Suisse Group structure and part of the International Wealth Management Division of Credit Suisse. CSAM focuses on the management of third-party assets, primarily from institutional clients.

3.9 The retail bank bidder withdrew. This left three bids, which were very similar in price. **Figure 11** shows how the bids changed between rounds. It can be seen that, on average, the bids reduced between Rounds 1 and 2. This was because of an increase in the cost of debt finance between the rounds, which reduced the price most of the investors were willing to pay.

3.10 The highest, and preferred, bidder was Cerberus, which agreed to pay £13.3 billion for the asset portfolio. This represents a £74 million (0.6%) premium to the par, or face value, of the assets – so for each £100 of loans, Cerberus offered £100.60.[17] Compared against the carrying value it represented a premium of £280 million.

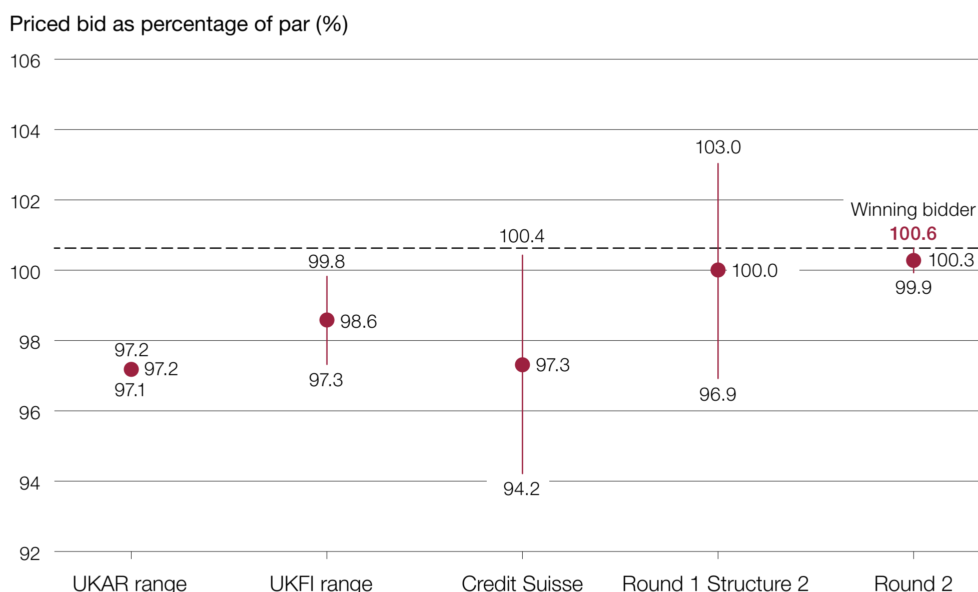
Sales proceeds

3.11 Cerberus acquired the asset portfolio for £13.3 billion (as at 30 June 2015), paying in two instalments. It made a first payment of around £12.8 billion in December 2015 when the economic interests in Granite transferred. It made a second payment of more than £0.5 billion when the shares in NRAM and legal titles of all mortgages and loans transferred. At this second stage, the legal title of the mortgages and loans remained with NRAM. **Figure 12** overleaf outlines the phasing of the payments.

Figure 11

Valuations and bids as a percentage of par value of the assets

Winning bidder offered 0.6% premium to par value, representing £74.3 million



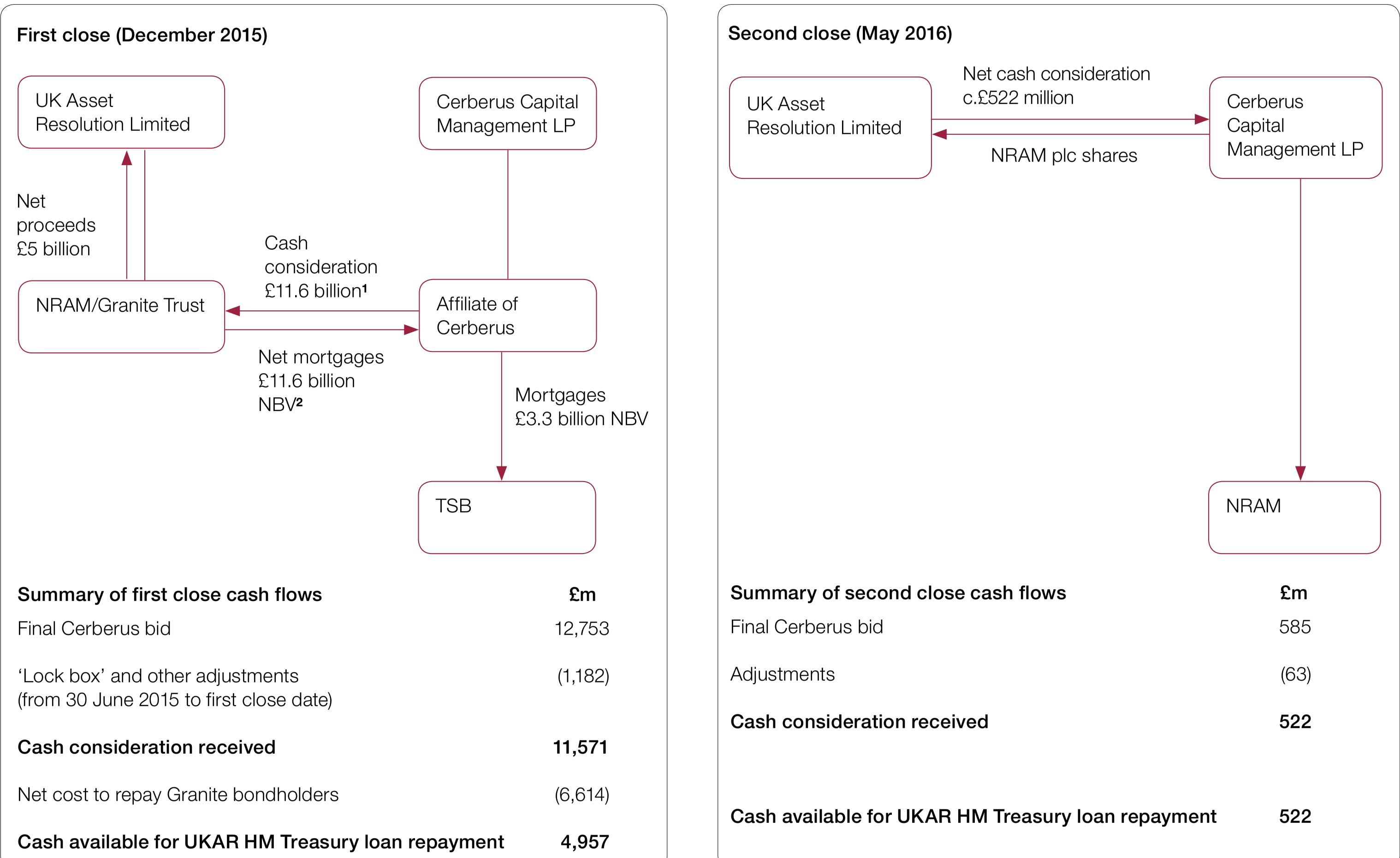
Source: National Audit Office

17 As part of the sale agreement UKAR indemnified the purchaser against certain actions of the previous owner – for example, litigation risk for mis-selling, such as payment protection insurance.

Figure 12

Flow of proceeds to UKAR

The net proceeds to UKAR amounted to £5.5 billion



Summary of first close cash flows	**£m**
Final Cerberus bid	12,753
'Lock box' and other adjustments (from 30 June 2015 to first close date)	(1,182)
Cash consideration received	**11,571**
Net cost to repay Granite bondholders	(6,614)
Cash available for UKAR HM Treasury loan repayment	**4,957**

Summary of second close cash flows	**£m**
Final Cerberus bid	585
Adjustments	(63)
Cash consideration received	**522**
Cash available for UKAR HM Treasury loan repayment	**522**

Notes

1 The cash consideration for first close was the final Cerberus bid of £12.8 billion, less the 'locked box' adjustments of £1.2 billion. This was paid in December 2015.

2 The net book value of the mortgages is as of June 2015 when the economic interest transferred to the buyers.

Source: National Audit Office

3.12 As borrowers paid down their mortgages, the pool of assets being bought was reducing. To simplify the transaction for the bidders and make bids comparable, it was agreed that 30 June 2015 would be the effective date of sale. This meant that, although the legal title to the company (NRAM) would only transfer when the deal closed, the economic interest of the assets, and any associated risks, would transfer as of June 2015. The economic interest accruing during this time period was captured in the 'locked-box' mechanism. This is not uncommon for this type of transaction.

3.13 During the 'locked-box' period the loans generated £1.2 billion of cash. Therefore, the total Cerberus had to raise was £12.1 billion, made up of an initial cash consideration of £11.6 billion paid in December 2015 and £0.5 billion in May 2016. Of this amount, £6.6 billion was used to repay Granite bondholders, and the remaining £5.5 billion cash was available for UKAR to pay over to HM Treasury (Figure 3 and paragraph 1.14).

3.14 As part of the deal, Cerberus sold £3.3 billion (25%) of the acquired assets to TSB Bank plc, a UK bank. It also sold beneficial title (but not legal title) of some of the assets to BAWAG, an Austrian bank 54% owned by Cerberus. Cerberus also chose to unwind the Granite securitisation and set up a new securitisation vehicle called Towd Point. It successfully sold £6.2 billion of securitisation bonds in April 2016.

Customer protection

3.15 UKAR considered how potential bidders might treat customers, in particular:

- how they would service loans, for example in dealing with customer queries or arrears;[18]
- changes to the terms and conditions of loans; and
- changes to interest rates on loans.

3.16 UKAR assessed bidders' customer treatment proposals extensively in the sales process. It included a pass or fail test in the bidder selection criteria and met with bidders to discuss fair treatment of customers. In addition, it hired an external adviser (KPMG) to carry out reverse due diligence on the bidders. This was undertaken at the beginning of Round 2 and limited to a desktop review. Given the uncertainties about the final structure of some of the bids, the review lacked clarity in some areas. For example, two of the four bidders had not yet finalised their 'bid companies' and so could not provide information on their arrangements for the oversight of the servicing contract or on their regulatory culture. UKAR considered, and rejected, a second round of reverse due diligence as it felt it risked delaying the sale and would not provide additional value.

18 The mortgage servicing aspects of loans were outside the scope of this audit. UKAR carried out a separate sale of the mortgage servicing platform (OpCo) at the same time as the NRAM asset sale. The bidders for NRAM had the choice of keeping the servicing of the loans with OpCo or transferring this to a third-party servicer. All bidders chose to use OpCo (which will also continue to service the loans remaining with UKAR). Under Project Phoenix the mortgages servicing in OpCo was transferred to Computershare in May 2016.

3.17 UKAR put in place specific protections in the sales contract with Cerberus (**Figure 13**), including a one-year 'lock-in' period that limits increases in the interest rate[19] to changes in the base rate. These conditions go further than is normal.

3.18 Beyond the one-year lock-in period, UKAR's view is that Financial Conduct Authority (FCA) regulation is the main way of protecting customers. The legal title to the loans sold by UKAR is held by either NRAM or TSB Bank plc, the UK retail bank.[20] Both NRAM and TSB are FCA-regulated (**Figure 14**). However, as with any other regulated UK mortgage, there are no restrictions on NRAM or TSB to selling on the legal title to the loans to unregulated entities in the future. The servicer of the loans is always required to be a regulated entity.

3.19 UKAR engaged with the FCA during the sales process and regularly discussed customer protection issues. The FCA considers that it has the legal powers to protect consumers under the arrangements which are in place following the sale.

3.20 In a case where the legal owner is no longer a regulated entity, customers would no longer benefit from the full regulatory protection offered via the FCA. They would need to rely on other regulations like the Consumer Rights Act or Unfair Terms in Consumer Contracts Regulations to seek redress, which could be prohibitively expensive for the most vulnerable customers as it typically involves legal fees. Alternatively, customers may also be able to complain to the Financial Service Ombudsman. The customers would continue to benefit from the servicer being regulated, which is bound by similar customer fair treatment rules as a regulated owner of the loans. This potential risk to customers applies to mortgages in general across the UK and is not specific to this transaction.

Figure 13

Protections in the contract relating to customer treatment

Time application	
One year	The buyer must: • deal with arrears in accordance with the seller's debt management principles; • only change the standard variable rate by reference to the base rate; and • keep early repayment charges at zero.
Two years	• UKAR has the right to audit compliance.
Indefinitely	The buyer must: • act in a way which is consistent with a prudent lender or any action taken by the seller over the past 3 years; • comply with relevant regulation, such as those of the Financial Conduct Authority; and • not de-link 'Together' loans.

Source: The contract with winning bidder

19 Standard variable rate.
20 The transfer of the legal title to the £3.3 billion of loans sold to TSB was expected to be completed in July 2016.

Figure 14
Regulatory environment

Before the sale of NRAM/assets

Asset owner	FCA regulated	Servicer	FCA regulated
NRAM plc	Yes	B&B	Yes
Granite Finance Trustees Limited[1]	No	B&B	Yes
After the sale of NRAM/assets			
NRAM plc	Yes	B&B/Computershare	Yes
CERH[2]	No	B&B/Computershare	Yes
Towd Point[3]	No	B&B/Computershare	Yes
TSB	Yes	B&B/Computershare	Yes

Notes

1 Granite Finance Trustees Limited is the owner of the Granite Master Trust. It was regulated by the FCA until September 2015, at which point it let its licence lapse as it was no longer a regulatory requirement.

2 CERH: Cerberus European Residential Holding. Dutch entity. Legal owner of NRAM via two UK entities. It is not the asset owner; it only receives the beneficial interest in the assets which it passed on to Towd Point.

3 Towd Point is the vehicle Cerberus used to securitise part of the mortgages in Granite after the first close of the transaction. Like Granite, Towd Point does not have to be regulated. It is not the asset owner; it only receives the beneficial interest in the assets.

Source: National Audit Office

Part Four

Valuation

4.1 This part compares the sale price of the asset with the government's valuations. It also examines the valuation model and the underlying assumptions, including the government's consideration of tax.

Sale price

4.2 The sale price of £13.3 billion exceeded four measures:

a £74.3 million, or 0.6%, over the par value of the loans;

b £276.2 million (2.2%) above the 'carrying' or 'book' value of the loans;[21]

c £459 million (3.6%) higher than UK Asset Resolution Limited's (UKAR) reserve price valuation of £12.9 billion; and

d £97.3 million (0.7%) higher than UK Financial Investments Limited's (UFKI) top end of its fair value range.

This means that UKAR exceeded its reserve price, and received more than it would have if the customers had paid off their outstanding obligations in full on the day of the sale (par value), and more than the value at which the loans are recorded on its balance sheet (carrying value) (**Figure 15**).

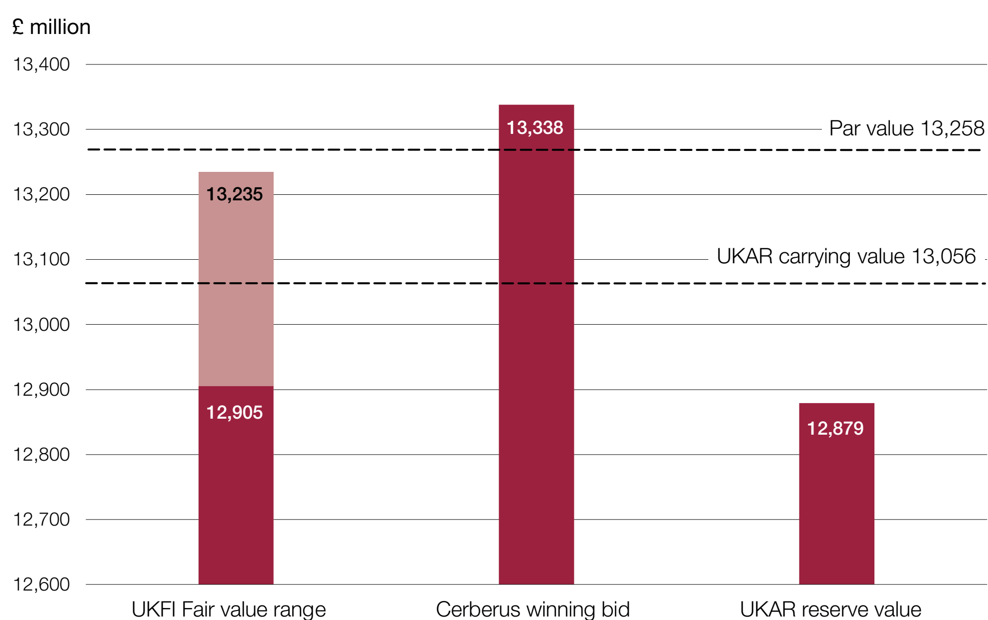
Assumptions and valuations

4.3 UKAR used a valuation model to calculate its reserve price for the assets. The accuracy and supporting evidence of the assumptions used in this model are critical: financing assumptions that are too conservative may lead to assets being sold too cheaply, and conversely, assumptions that are too aggressive may lead to an unrealistically high valuation and the transaction not occurring. The key valuation drivers for this asset sale can be grouped into two categories: those affecting the cash flow of the underlying mortgages and loans; and those concerning the financing structure used in the acquisition. The cash flows of the assets are discounted by the cost of capital (the financial drivers) to establish the value of the assets. **Figure 16** summarises the key assumptions.

21 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. The carrying or book value is the value of the loans in the financial accounts, which include downward adjustments for expected losses.

Figure 15
Valuations and winning bid

The winning bid was higher than UKFI's and UKAR's valuations



Source: National Audit Office

Figure 16
Key assumptions and valuation drivers

Financial drivers	**Asset drivers**
Cost of debt	Pre-payment rate
Cost of equity	Default rate
Debt/equity split	Severity of loss
Interest rates	House price assumptions

Source: National Audit Office

4.4 UKAR and its advisers approached their valuation calculation in different ways. Credit Suisse, the adviser, calculated the 'fair value' of the assets to a prospective buyer type – private equity or retail bank, based on the transaction structure set out in UKAR's Information Memorandum.[22] UKAR took a buyer and structure neutral view to derive a single 'point' value, its 'reserve price', based on the fundamental value of the assets. UKAR's neutral view meant that it assumed no difference between different buyers and what they might pay for different structures. As a result, the individual financing assumptions differed between UKAR and its advisers. Some of UKAR's assumptions had a conservative bias. For example:

- UKAR assumed that bidders would require a 20% equity return. This rate was higher than the equity return implied by the price paid in the recently completed sale of £2.7 billion of mortgages. UKAR felt the large size of the transaction, and thus higher execution risk, warranted the increased estimate on returns to equity. The higher equity return assumption reduced the reserve price; and
- UKAR assumed that the finance required to purchase the assets would be split 87:13 between debt and equity. Advisers used a more aggressive finance split of 93:7 for private equity buyers and 95.5:4.5 for bank buyers. A lower debt component in the financing is beneficial for the cost of debt but increases the average overall cost of finance, as debt is cheaper than equity, and therefore it reduced the reserve price calculation.

However, UKAR assumed an average overall cost of debt required to finance the transaction of Libor+150 basis points (bps). This was at the low end of the range used by UKAR's advisers and therefore increased the reserve price.[23] The less conservative assumptions on the cost of debt counteracted the more conservative assumptions about the equity. Therefore, despite the differing assumptions of UKAR and its advisers, the cost of capital used to discount the cash flows and create the valuation, which is a function of cost of debt, cost of equity and debt to equity split, were similar.

4.5 A fair-value calculation should represent the potential market price of an asset. When the assumptions related to different prospective bidders diverge substantially, as illustrated by the cost of debt, calculating the fair value of the assets neutral to bidders and structure requires professional judgement and the outputs should be cross-referenced with advisers to ascertain the validity of the inputs. UKAR achieved this in its valuation but we would encourage separate valuations (based on different bidder types and sale structures) to determine value ranges.

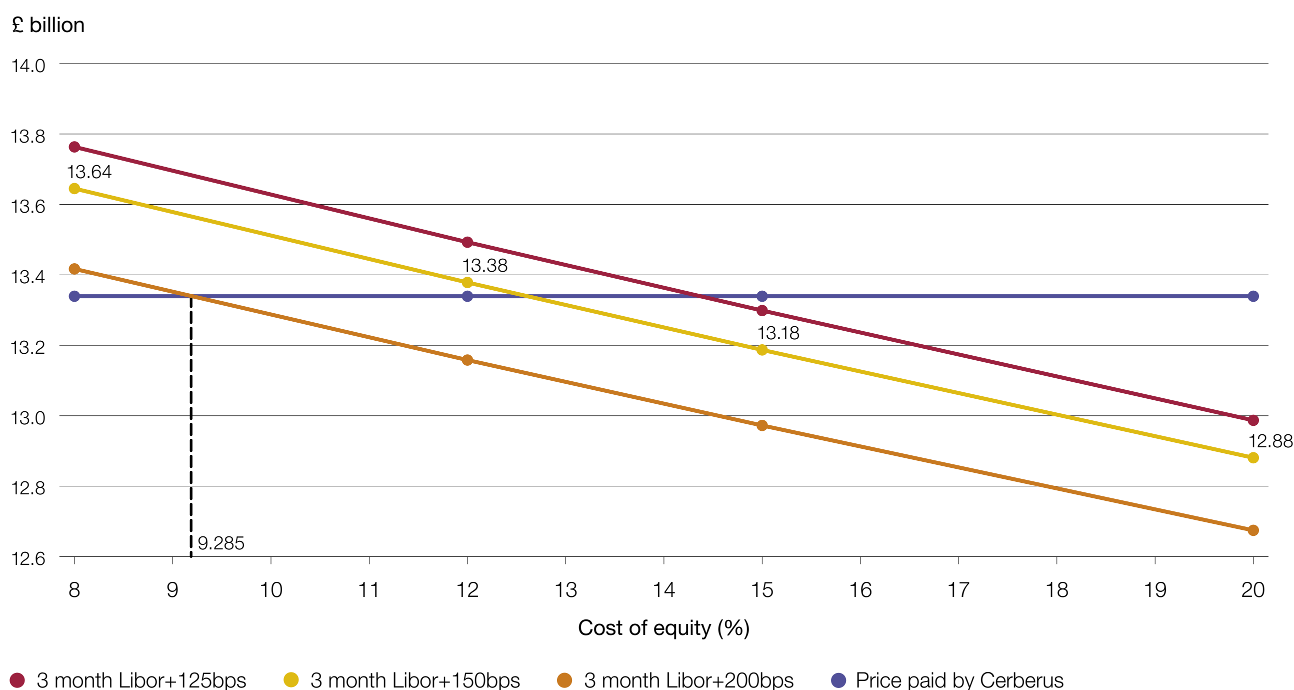
22 The Information Memorandum is an information pack provided to prospective bidders on the assets to be sold.
23 UKAR's advisers used a range of Libor +130 to 260bps where the lower and upper ends represent the estimated cost for bank and private equity buyers respectively.

4.6 UKFI used UKAR's model to develop its own valuation. It used the same asset assumptions and made amendments to the financing assumptions. The financing assumptions included a range of 15%–20% for the cost of equity, and slightly different cost of debt and discounting assumptions. The resulting fair value was a range, with the top end £356 million higher than UKAR's reserve price and therefore closer to the winning bid (within 0.7%). Figure 11 on page 29 demonstrates CS, UKAR and UKFI's different valuations. We are in a position to use the benefit of hindsight to examine the gap between the final price and the valuation model. Using UKAR's cash flow model, and applying the average cost of debt Cerberus achieved in the securitisation market to partially finance the transaction, we can derive the implied cost of equity. We estimate their cost of debt to be in the region of Libor+200bps, which implies a cost of equity between 9% and 10% based on UKAR's model (**Figure 17**). This sensitivity analysis is not intended to represent an alternative valuation of the mortgages. Rather, it represents an illustration of the sensitivity of the valuation to the cost of equity and debt.

Figure 17

Sensitivity analysis on UKAR valuation model

Keeping other things in UKAR's valuation constant, the price Cerberus paid implies a cost of equity of approximately 9-10%



Notes

1 The graph represents the sensitivity of UKAR's valuation model to the cost of equity (x-axis) and the cost of debt (y-axis). The horizontal line represents the price paid by Cerberus (£13.34 billion). The yellow line represents UKAR's model sensitivity to the cost of equity. UKAR assumed it to be 20% and arrived at the reserve price of £12.88 billion. If the cost of equity was assumed to be 15%, 12% or 8% the reserve price would have been £13.18 billion, £13.38 billion and £13.64 billion respectively. The figures were calculated by adding adjusted share price to the book value before equity.

2 The orange and red lines represent UKAR's model sensitivity to the cost of debt. If the cost of debt moved by 25 basis points either way, the effect on the reserve price would be approximately £100 million. The 3 month Libor+200bps scenario illustrates Cerberus' implied cost of equity based on UKAR's financial model.

Source: National Audit Office

4.7 UKAR and UKFI used a single valuation methodology to calculate the fair value of the asset portfolio. It calculated the net present value of the future cash flows of the assets and adjusted it by the net equity value of the company, Northern Rock (Asset Management) Plc (NRAM). Another approach would be to consider NRAM's net cash flows. Both valuation approaches were illustrated in the documentation supporting the valuation model but the alternative valuation method (based on NRAM's net cash flows) was not conducted. Multiple valuation methodologies can act as a cross-check and be used to set valuation ranges.

4.8 The presentation of the valuation and bids during the execution of the transaction could have been more consistent. The presentation of the external bids changed as the likely transaction structure emerged. This made understanding the bids, and how they had changed over time, difficult. During the first round of bids the presentation focused on the loan repayments to the government resulting from the sale, whereas in Round 2 it focused on the total proceeds. The assumptions were based on market data and UKAR's experience; however, the documentation of the evidence base used to inform and support UKAR's professional judgement could be improved.

4.9 In addition to its reserve price valuation, UKAR calculated a 'taxpayer break-even' which took account of not having to pay the future interest on certain debt within the Granite structure, which had a higher cost of borrowing than government gilts. This taxpayer break-even price was approximately £230 million below the reserve price. All parties, including HM Treasury's accounting officer, agreed that if bids were between the taxpayer break-even and reserve price they would need to carefully consider whether the transaction still represented value for money for the taxpayer; and they had concerns about the applicability of the taxpayer break-even price in a sell decision. We share these concerns as these financing savings are not conditional on the sale, as the government could choose to refinance at any time. As the winning bid was above the reserve price, the lower taxpayer break-even price did not have to be considered as part of the decision to sell.

Alternative sales option

4.10 At the time of the sale launch, UKAR marketed the sale as an asset portfolio alongside the securitised debt in Granite. However, all final-round bids assumed that the securitised debt would be refinanced. The valuation model did not calculate the financial benefit of breaking up the Granite securitisation structure (by repaying the liabilities linked to the assets) and selling the assets in a single tranche or multiple tranches. The first round of bids in June 2015 suggested that a number of bidders were considering whether to refinance Granite. UKAR's Transaction Approvals Committee (TAC) asked for an alternative analysis to be done on a Granite break-up valuation.

4.11 In September 2015, UKAR presented its further analysis to TAC. The analysis concluded that breaking up Granite followed by a single sale or multiple sales could increase the reserve price by between £48 million and £307 million. The higher figure was based on multiple sales and the increase was mainly due to a lower cost of equity to reflect the lower risk of smaller, less complicated, transactions. UKAR assumed that the multiple sales would extend the execution period by up to 27 months and therefore expose the value of the asset to changes in market conditions. Adjusting UKAR's reserve price for the market execution risk, it estimated the increase to be £98 million (0.8% of par value) with possible further downside risk due to potential future adverse movements in the markets. Subsequent advice from HM Treasury and UKFI to the accounting officers noted that "although a theoretical case can be made for the potential to exist to achieve greater value from the unwind and sale over time of Granite assets, on a risk adjusted basis UKAR believe and UKFI agree that this theoretical benefit is likely to be marginal and in practice very materially outweighed by asymmetric risks to the downside (including further margin compression with rising rates and an increase in impairments) which render the marginal theoretical value benefit unlikely to materialise in practice". All parties therefore concluded that continuing the original sales process provided tax payer value.

4.12 The alternative sale option analysis suggests that smaller, more targeted sales could in theory have a positive effect on UKAR's valuation. A sale in multiple transactions could have addressed investor concerns raised during market testing surrounding the size of the sale and the type of assets being sold. Bank investors, for example, had size limitations and were interested primarily in higher-quality mortgages, which is reflected in the price they are willing to pay for portfolios including lower-quality loans. Based on the submitted bids, banks were willing to pay up to 103.25% of the par value on Granite mortgages compared with 101.43% for private equity buyers. On lower-quality loans the reverse is true, with private equity buyers willing to pay more (**Figure 18** overleaf).

4.13 UKAR and UKFI, however, felt that a single large transaction was advantageous for several reasons:

- **a** it accelerated the run-down of UKAR's assets, reducing the exposure to market risk;
- **b** bidders paid a premium for the scale of the transaction, for example, because multiple transactions would create multiple bid costs; and
- **c** it would have been difficult to sell different asset classes in Granite to different buyers as some mortgages and unsecured loans in the portfolio were linked together and a separation would have been technically difficult and could have resulted in customers not being treated fairly (see paragraph 2.6).

In addition, a break-up would have required HM Treasury to agree to a £8 billion capital injection to refinance the private debt.

Figure 18

Offers by type of loan and buyer – premium/discount to par (%) ranges

Bank-type buyers are wiling to pay more for performing loans, while private equity buyers will pay for non-performing and unsecured loans

	Bank-type buyer	Private equity-type buyer
Granite mortgages	101.09% – 103.25%	101.43%
Unsecured loans	65.03% – 74.50%	77.00% – 78.56%
Terms & conditions loans	101.09%	102.50%

Source: Bidder submission documents, National Audit Office

Tax considerations

4.14 The amount of UK tax a future buyer pays is relevant to the taxpayer. A bidder paying more up front but using a structure that minimises UK corporation, for example by being domiciled overseas for tax purposes, may provide less revenue for the Exchequer over the long term.

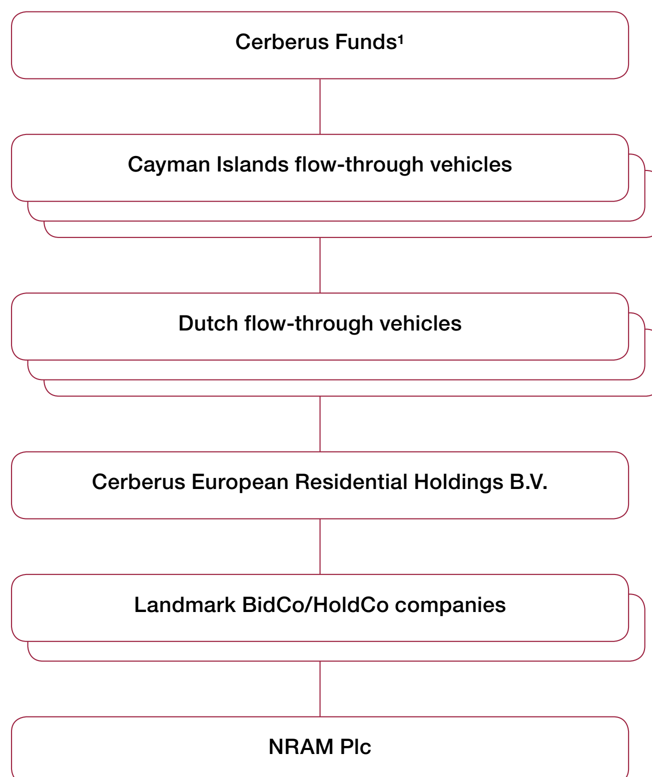
4.15 The valuation model forecasts that over the next five years the portfolio's profit before tax would be around £200 million each year. The model, which was designed to value the assets rather than forecast tax payments, assumed no UK corporation tax on these profits. Had a UK banking company earned these profits, the total UK corporation tax due over this period would have been approximately £50 million a year.[24]

4.16 UKFI and HM Treasury told us that they did not take account of potential future tax revenues paid in the UK when selecting the bidders as they thought this would be deemed discriminatory against bids from other European Union (EU) member states and therefore against EU rules. As a result, they did not ask for information on this or attempt to estimate it. However, UKAR and UKFI did make an adjustment for the treatment of tax paid between 30 June 2015 and the closing of the transaction to make bids comparable (during the locked-box period). Irrespective of this adjustment, the winning bidder would have been the same.

4.17 The winning bidder is an affiliate of Cerberus, a US-based private investment firm. Cerberus European Residential Holdings (CERH), which bought the assets, is a private company based in the Netherlands and was set up specifically for this transaction. CERH is owned by a series of vehicles based in the Netherlands and the Cayman Islands with a complex holding structure (**Figure 19**). Cerberus first established its business in the Netherlands in 1998 and pays corporation tax in the Netherlands. However, it noted that, in the year ending March 2016, the UK tax paid on the profits of the portfolio, and arising due to the sale to CERH, was more than £100 million. Most of this tax was paid when UKAR still owned the assets so the UK tax paid on these assets is likely to fall in future years. As part of the transaction, Cerberus sold £3.3 billion of assets to TSB Bank plc, a UK bank.

24 UK banking companies are subject to the main corporation tax rate, which is reducing from 20% to 18% over the next five years, plus a surcharge of 8%.

Figure 19
Cerberus' ownership diagram



Note

1 The Cerberus Funds are managed by Cerberus Capital Management, L.P. (an SEC-registered entity) or one of its affiliates.

Source: Bidder submission documents

Appendix One

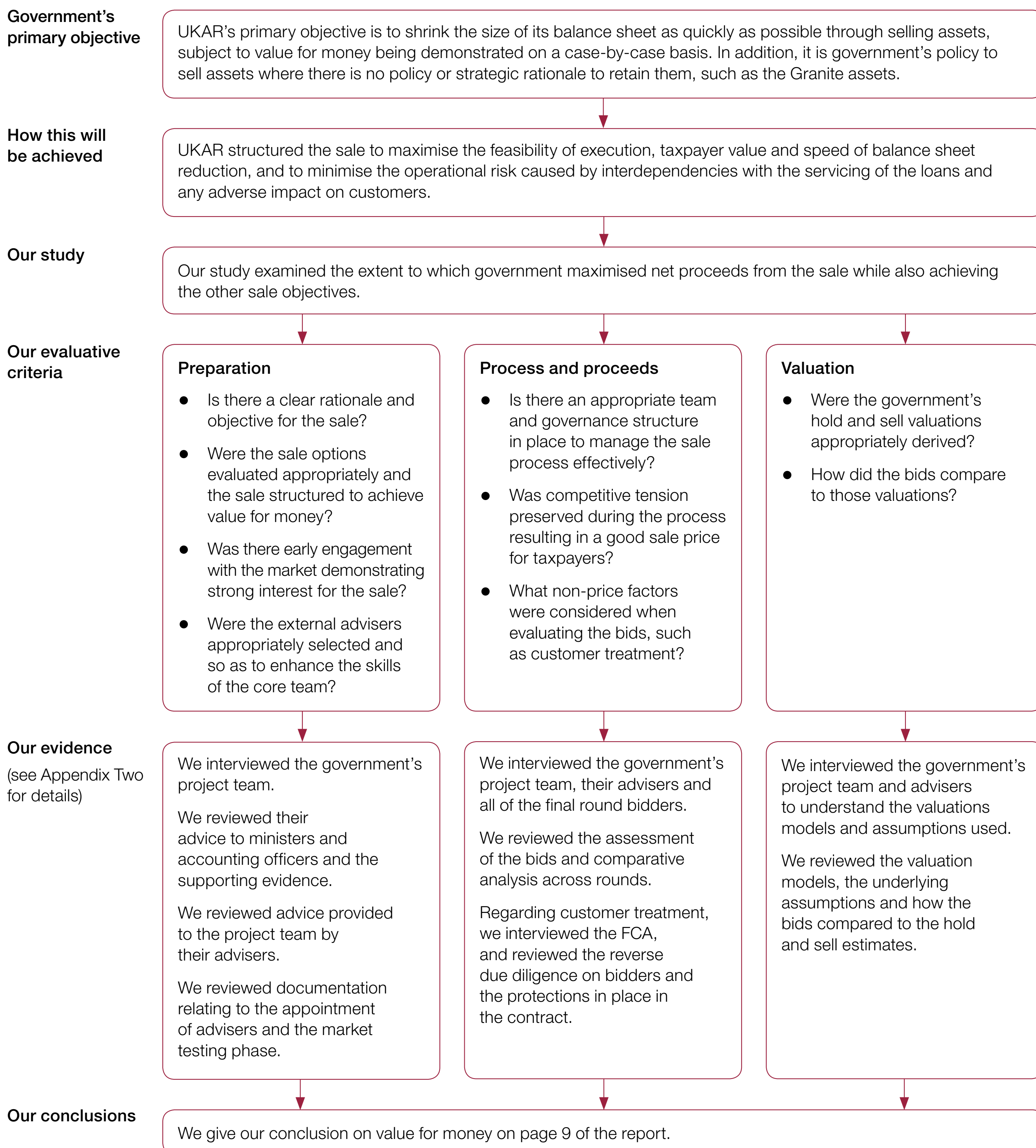
Our audit approach

1 This study examined whether the government achieved value for money from the sale of the £13 billion asset portfolio of Northern Rock (Asset Management) plc. It covers:

- the **background** to the sale;
- **preparations** for the sale;
- the sale **process and proceeds**; and
- the **valuations** produced by government and its advisers.

2 **Figure 20** gives our evaluative criteria. Our evidence base is described in Appendix Two.

Figure 20
Our audit approach



Appendix Two

Our evidence base

1 We collected and analysed our evidence between January and April 2016. Our main methods were:

Semi-structured interviews with the parties involved in the sale process

- **Government** – We spoke to HM Treasury, UK Financial Investments (UKFI) and UK Asset Resolution (UKAR).
- **Advisers** – We spoke to Credit Suisse and Moelis, which respectively advised UKAR and UKFI.
- **Bidders** – we spoke to the winning bidder, Cerberus, and to other bidders in the final round.
- **Other parties** – We spoke to KPMG, which did the due diligence on the bidders, and the Financial Conduct Authority on the regulations in place for protecting mortgage owners.

Reviewing documents

- We reviewed transaction documentation such as the Information Memorandum and the contract signed with the winning bidder.
- We reviewed advice provided by the advisers and due diligence providers.
- We reviewed board papers and minutes of UKFI, UKAR and HM Treasury, and the advice they submitted to ministers and accounting officers.

Data analysis and valuation

- We analysed data on the composition of the asset portfolio.
- We examined the different valuation models that were used and their underlying assumptions.
- We compared the level of bids made during the sales process.
- We reviewed and analysed data to understand the impact on the public finances.

Appendix Three

Northern Rock – key events

Figure 21
Northern Rock – key events

Key events that led to the sale of Granite/NRAM Plc

Date	Event
1965	Northern Rock Building Society formed.
1997	Becomes a bank after demutualisation and floatation on the London Stock Exchange.
2001	Granite securitisation vehicle created.
September 2007	Northern Rock granted emergency funding by the Bank of England.
February 2008	Nationalised.
November 2008	UK Financial Investments Limited (UKFI) is established with responsibility for managing taxpayers' interests in the wholly owned banks.
January 2010	Northern Rock is split into two companies: Northern Rock Plc and Northern Rock (Asset Management) Plc (NRAM).
October 2010	UK Asset Resolution Limited (UKAR) is established as the holding company for the taxpayer interests in NRAM and Bradford & Bingley.
January 2012	UKFI sells Northern Rock to Virgin Money for around £1 billion.
July 2013	UKAR sells a portfolio of stand-alone unsecured personal loans for £400 million.
October 2014	Sale of £2.7 billion of NRAM mortgages to a JP Morgan-led consortium. UKFI and UKAR begin planning for a significant mortgage book sale.
March 2015	Budget 2015 announces sale of NRAM (including the Granite vehicle) and the outsourcing of mortgages servicing activities.
March – July 2015	Covered bonds are bought back to enable NRAM sale (Project Cheviot).
November 2015	UKAR announces Cerberus as winner of NRAM sales process, selling c.£13 billion of assets and providing net cash proceeds of c.£5 billion for the taxpayer. First stage of transaction closes in December.
March 2016	2016 Budget announces sale of £17.5 billion former Bradford & Bingley loans over the next two years.
May 2016	Second stage of NRAM/Granite sale closes on 5 May 2016.
May 2016	UKAR announces the transfer of its mortgage servicing operations to Computershare.

Source: National Audit Office

Appendix Four

Overview of the sale process

Figure 22

Overview of the sale process

	Pre-qualification process	Round 1	Round 2	Completion and final bidder announcement
Timing	Jan 2015 – Mar 2015	Apr 2015 – Jun 2015	Jun 2015 – Sep 2015	Oct 2015 – Nov 2015, finalised in May 2016
Purpose	Invite potential investors to express interest and discuss the project	Provide information on the project for the bidders and receive initial bids	Provide the shortlisted bidders with further detailed information and the ability to ask questions	To finalise the sale
Information provided to potential investors	Marketing document containing concise information on the asset portfolios A letter setting out key questions that needed to be answered Potential bidders were granted one in-person meeting with UKAR	Information Memorandum Access to the data room	Information Memorandum Access to the data room Ability to ask questions and participate in site visits Due diligence meeting with UKAR management	No further information provided
Number of potential investors	Five parties invited to the market testing	63 parties expressed interest and sign non-disclosure agreements	4 bidders	1 winning bidder
Equity value (adjusted share price)	n/a	-£113.8 million to £756.2 million (£375 million average)	£725.1 million to £810.7 million (£780.1 million average)	£810.7 million
Discount/premium to par	n/a	-£443 million to £427 million (£18 million average)	-£11.3 million to £74.3 million (£43.7 million average)	£74.3 million
Discount/premium to par (%)	n/a	96.9% to 103%	99.9% to 100.6%	100.6%
Result	Confirmed investor interest Decided on the sale structure	Six bids. One bidder withdrew from participating due to conflicts of interest. Four bidders invited to Round 2	Three bids. Top two bids very close to each other. One bidder withdrew from the process after Round 2 due diligence	The highest bidder, at £810.7 million, was selected

Note

1 The Round 1 bids were based on the illustrative balance sheet as at 31 January 2015. The Round 2 bids were based on the balance sheet as at 30 June 2015.

Source: National Audit Office

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