Reshuffling in the banking sector during the financial crisis: the Northern Rock case

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1. Introduction

In normal circumstances the exit of inefficient firms is part of a self-correcting mechanism in the market. In this way market-based competition penalises those who make less efficient choices about how they organise themselves, what risks they take and what they produce. Unconditional State support granted to companies in difficulties would hinder the necessary adjustment process and generate harmful moral hazard. As a result, the provision of rescue or restructuring aid to companies in difficulty is generally considered as highly distortive to the markets and may only be regarded as legitimate subject to strict conditions.

In the context of the financial crisis the Member States generally intervened to rescue failing financial institutions in order to prevent harmful spillover effects such as a bank run and to ensure overall financial stability. Justified as these interventions may be from the financial stability perspective, the rescue of the banks raises questions regarding moral hazard and distortions of competition.

In order to deal with these issues, the Commission adopted a Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (2) (the ‘Restructuring Communication’). It contains the following conditions for restructuring aid to banks to be approved:

(i) A restructuring plan, which has to rely on prudent economic assumptions, must provide for restoration of the bank’s long-term viability (with no further aid) and has to be fully implemented.

(ii) The amount of aid must be limited to the minimum to cover the restructuring costs necessary to enable proper restructuring and, where appropriate, to prevent credit supply restrictions and limit the pass-on of the financial markets’ difficulties to other businesses. To this end, the bank and its capital holders should contribute to the restructuring as much as possible with their own resources. The latter is necessary not only to minimise the aid, but even more importantly in order to ensure that rescued banks bear adequate responsibility for the consequences of their past behaviour and to create appropriate incentives for their future behaviour.

(iii) Measures must be taken to mitigate as far as possible any adverse effects of the aid on competitors.

In this context, on 28 October 2009 the Commission authorised, under the EC Treaty rules on State aid (Article 88(2)), a package of measures to support the restructuring of Northern Rock (3).

2. Beneficiary

Before the difficulties started in the second half of 2007, Northern Rock (‘NR’) was the fifth biggest UK mortgage bank with a balance-sheet total of GBP 113.5 billion on 30 June 2007 and GBP 109.3 billion at the end of 2007. The bank had 77 branches throughout the United Kingdom and was present in Ireland, Denmark and Guernsey. Residential mortgage lending was and remains NR’s core activity. This represents more than 90% of all outstanding loans in its loan portfolio. In the first half of 2007, the bank had a market share of UK gross mortgage lending of 9.7% and of net mortgage lending of 18.9% (4).

Banks raise funds to lend to mortgage customers by two principal means. One is by the use of funds deposited in accounts by retail and commercial depositors. The other is by borrowing money on the wholesale funding markets. NR financed the majority of its long-term mortgage loans by raising short-to mid-term funding on wholesale financial markets. This included short-term borrowing in the financial markets, issuing bonds (in a variety of forms) and undertaking securitisations, notably by issuing residential mortgage-backed securities through a ‘master trust’ established in 2001. As a result, NR became increasingly present in securitisation markets. Meanwhile, a continuously declining share of its funding came from retail deposits. On 30 June 2007, retail

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(1) The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the authors.


(4) Gross lending is total advances, and net lending is advances less redemptions and repayments.
deposits amounted to only GBP 24 billion out of a balance-sheet total of GBP 113 billion.

NR was one of the first banks to be hit by the financial crisis. NR’s dependence on wholesale funding caused difficulties in the second half of 2007 when the mortgage securitisation market collapsed. It suffered a bank run in September 2007. NR’s funding problems as exacerbated by the bank run led the UK authorities to intervene.

3. State measures

NR benefited from several aid measures of different types to enable it to cope with the effects of the financial crisis. At the very beginning of the crisis, in September 2007, the UK authorities provided a guarantee on all existing retail deposits (savings), as far as they were not covered by the UK deposit guarantee scheme, in order to stop the run on the bank. This guarantee was accompanied by a liquidity facility. Both measures were approved by the Commission on 5 December 2007. The guarantee on existing retail deposits was later extended to new retail deposits and several types of unsubordinated wholesale deposits. This was necessary in order to avoid a ratings downgrade by the ratings agencies which would have had serious consequences for NR’s ability to raise funds on the capital markets. The changes made to the guarantee were approved by the Commission on 2 April 2008.

After nationalising NR on 17 February 2008, the UK authorities submitted an initial restructuring plan for NR. This plan focused on the return of NR to the market as a whole entity after restructuring. However, with the financial crisis reaching its peak at the end of 2008, it soon became apparent that the plan had to be amended to take into account the dramatic changes in the financial markets. The second restructuring plan the Commission received included a split-up of NR into two parts resulted in aid being granted to BankCo. The Commission concluded that the split-up had the effect of an asset relief measure, as BankCo would be relieved of the impaired assets and resulting losses which would stay with AssetCo. The Commission furthermore found that the aid was substantial as the assets were transferred from NR to AssetCo at book value, which is reasonably expected to be above their real economic value, thus necessitating a far-reaching restructuring.

4. Procedural steps

The entire procedure in the NR case encompasses four decisions taken over a period of just over two years. The first decision was the rescue decision of 5 December 2007, followed by a decision opening the formal investigation procedure on the initial restructuring plan and approving the extension of the guarantees on retail and wholesale deposits, taken on 2 April 2008. A little over a year later, on 7 May 2009, the Commission extended the formal investigation procedure to cover the new restructuring plan. The final decision on the second restructuring plan was taken on 28 October 2009.

As regards the legal basis of the Commission’s decisions, the rescue decision and the decision of 2 April 2008 to open the formal investigation procedure were taken on the basis of Article 87(3)(c) of the Treaty and the Rescue and Restructuring Guidelines. The reason for this was that the Commission considered that the difficulties NR was facing were linked to problems specific to NR and therefore did not justify the application of Article 87(3)(b). As the severity of the financial crisis af-

(?) The Financial Services Compensation Scheme (FSCS), a UK national scheme funded by the banks which compensates retail deposit holders in case of the failure of a financial institution for a maximum amount of GBP 50 000.


fected more and more banks, in September 2008 (12) the Commission accepted the application of Article 87(3)(b) to banks that received State aid from then onwards. Therefore, the decision extending the formal investigation procedure and the final decision were taken on the basis of Article 87(3)(b) of the Treaty.

5. Assessment of restructuring aid to Northern Rock

The restructuring plan submitted by the UK authorities on 7 May 2009 was subsequently amended by the UK. The final version of the restructuring plan was submitted on 10 June 2009 and was the basis of the Commission’s final decision in the NR case. In it the UK authorities outlined their proposal for the split-up of NR and how the plan fulfilled the requirements of the Restructuring Communication as regards return to viability, burden-sharing and own contribution and measures limiting the distortion of competition.

5.1. Return to viability

The main aim of this part of the assessment of a bank’s restructuring plan is to verify whether the bank post-restructuring will be a viable entity that will be able to stand on its own feet in the medium to long term without further State support.

In its assessment of the restructuring plan for NR, the Commission focused its viability assessment on BankCo, the new bank that would be the institution competing on the market after the split-up of NR, as AssetCo would be used as a mere vehicle holding the impaired assets transferred to it at the split-up and would no longer be competing on the market.

The Commission therefore first verified whether the macroeconomic assumptions underlying the plan were reasonable, in both the base case and the stress case. To this end, the assumptions were compared to forecasts by, among others, the Commission, the IMF and the OECD. The Commission found that the assumptions were reasonable.

The next step consisted in the assessment of the business model and business plan for BankCo. The Commission had to investigate whether the split-up of NR into BankCo and AssetCo addressed the main difficulties experienced by NR, namely the significant impairments on its loan book due to the financial crisis and economic recession and its reliance on wholesale funding to finance its lending activities. It found that directly after the split-up, BankCo would be a much smaller bank, approximately one fifth of the size of NR before the crisis. At the end of the restructuring period, BankCo would be around one third of the size of NR pre-crisis. It furthermore would have assets of high quality and a considerable amount of cash, while its liabilities would mainly be retail deposits and only a limited amount of wholesale funding. Thus, it would have both good quality assets and a proper funding base. The latter is essential as the situation in the financial markets has not stabilised yet. As a result, it should be a robust and healthy bank. The Commission furthermore found that BankCo’s commercial strategy would be more conservative compared to that of NR prior to the crisis, aiming at less risky lending. The same applied to BankCo’s funding of its activities, which would be predominantly based on retail deposits. Due to its limited size after the split-up, BankCo’s market share would be relatively small. The business plan furthermore showed that BankCo would be able to fulfil all relevant regulatory requirements in both a base case and a stress case and that it would return to profitability in the medium term in both scenarios.

The Commission therefore concluded that BankCo would be a viable bank and that its doubts regarding the viability were allayed.

5.2. Burden-sharing and own contribution

To address distortions of competition and moral hazard, the aid should be minimised and the bank and its capital holders should contribute to the restructuring as much as possible with their own resources.

In its assessment the Commission took into account the objective of ensuring continued lending to the real economy and concluded that the aid was limited to the minimum necessary. The Commission considered that this was justified in the exceptional circumstances of the financial crisis and, in particular, due to its effects on the UK mortgage market. In this context, the Commission observed that in 2008 and 2009 NR had already reduced its lending to very low levels compared to the situation before the State’s intervention, as the bank had been encouraging its customers to transfer their loans to competitors through its active mortgage redemption programme. This was deemed necessary to address competition concerns caused by the continued rescue aid. Notwithstanding the above objective, the market presence which the bank was allowed to have was significantly reduced compared to the situation before the State’s intervention (see section 5.3 below).

The Commission also found that NR and its capital owners had contributed to the restructuring to the maximum extent. The bank was nationalised and its

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(12) The first case to be decided under Article 87(3)(b) was in fact Bradford & Bingley, see Commission decision in Case NN 41/2008, OJ C 290, 13.11.2008, p. 2.
former shareholders would only be compensated on the basis of the value of the company without any State support. As this compensation would represent fair value of the company without the aid (and was likely to be limited in this case), the former shareholders were considered as having sufficiently supported the consequences of the failure of NR. Since NR’s subordinated debt holders would remain with AssetCo, they would be compensated through the amounts that were recovered from AssetCo’s assets. Also, the management of NR had been replaced during the crisis.

5.3. Measures to limit distortions of competition

In order to keep NR in business since September 2007 and to facilitate the split-up, a large amount of aid was and will continue to be necessary. As a result, the distortions of competition caused by NR are significant. NR’s successor BankCo will be well-funded and relieved of the burden of the risky lending made by NR in the past. The Commission and the third parties intervening in the procedure were concerned by the distorting effects of such aid.

As a result of intensive negotiations with the UK, a comprehensive set of measures limiting the distortion of competition and addressing the concerns voiced by the Commission and notably the bank’s competitors has been put in place by the United Kingdom. Firstly, NR has been subject to profound in-depth restructuring. As a result, a much smaller bank, BankCo, will compete on the UK retail market. Secondly, the bank’s market presence in its core markets of UK mortgage lending and UK retail funding was reduced by at least around 20-25% and its international presence limited through its withdrawal from Denmark. Caps introduced on BankCo’s retail deposits and mortgage lending will limit BankCo’s ability to expand aggressively on the market. Thirdly, to address the concerns raised by third parties as to BankCo’s ability to crowd-out competitors through aggressive pricing strategies, the United Kingdom has given a commitment that BankCo will stay out of the Moneyfacts top 3 tables as regards mainstream mortgages. In this context, the Commission considered that for smaller banks, such as BankCo, it is important to be visible in the Moneyfacts table (the top 5 prices are visible) as it is an effective way to come into contact with customers. The United Kingdom’s commitment ensures that BankCo, although still visible, cannot offer the best price on the market. Thus, potential crowding-out of competitors is limited during the years when BankCo is most reliant on State aid.

Furthermore, the United Kingdom has given a commitment to sell BankCo. Timely exit from temporary public ownership (TPO) ensures that third parties have the possibility to acquire BankCo. In that respect, NR’s competitors complained, above all, that while in TPO it is easier for NR to attract retail deposits as consumers are aware that the bank is State-supported. Putting an end to TPO will remove this distortion of competition. The United Kingdom has also given a commitment that the guarantees on retail and wholesale deposits for BankCo will be withdrawn by a specified date. Since this form of aid was considered as particularly distorting by the third parties having commented in the context of the in-depth investigation procedure, this commitment adequately addresses competitors’ concerns. As regards the guarantee on retail deposits, the UK authorities gave notice on 24 February 2010 that the guarantee would be lifted three months following the notice, on 24 May 2010.

Finally, BankCo will be limited in its activities by an acquisition ban and a ban on promoting the State guarantees and TPO.

6. Conclusion

This case is important for the following reasons. Firstly, it illustrates how a Member State, in this case the UK, may adequately address competition distortions in a timely manner by introducing behavioural constraints immediately after the rescue phase and before the Commission takes a final decision on restructuring aid. Such an approach is incentivised by the Commission, as these measures can be taken into account from the moment they are imposed upon the beneficiary.

Secondly, it provides an example of a comprehensive package of measures to limit distortions of competitions, where an amount of aid is particularly high and no or only limited effective divestitures can be envisaged. In such cases it is in particular necessary to set up mitigating measures targeting the core markets of the beneficiary bank, as was the case with NR, where both its lending and funding operations were significantly reduced and capped. It is also one of the first State aid cases where pricing constraints were imposed on the bank.

Thirdly, it provides an example to the Member States of a restructuring method that ensures maximum burden sharing by the former capital holders of a highly distressed bank.