

Northern Rock: The impact of public support on competition

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1 EXECUTIVE SUMMARY

- 1.1 In August 2007, Northern Rock plc began to experience extreme funding difficulties as a result of a liquidity shortage in the wholesale money markets. These difficulties led to the Government granting various public support mechanisms to Northern Rock. The bank was taken into temporary public ownership (TPO) in February 2008. The granting of public support and the subsequent TPO represented a watershed moment. At the time, Northern Rock was unique amongst banks in receiving public support and, as a result, there were genuine concerns about the impact its public support could have on the wider banking market.
- 1.2 In response to these concerns, the Chief Secretary to the Treasury, Yvette Cooper MP, made a commitment that the OFT would 'publish an annual report assessing any competitive implications of the public support for Northern Rock' during the parliamentary debate of the Banking (Special Provisions) Bill in February 2008. The Bill resulted in the temporary public ownership (TPO) of Northern Rock. This report fulfils that commitment.
- 1.3 Since Northern Rock was taken into TPO, the market has changed considerably. Many of the initial concerns about the impact on competition of public support for Northern Rock must now be seen in a wider context of very significant public support for the whole banking sector. The OFT's analysis was also limited by the many structural breaks in the data. These breaks occurred because of the continued financial instability during the period of analysis.
- 1.4 Against this backdrop, the OFT has considered whether public support for Northern Rock had a significantly adverse impact on competition in the relevant markets during the period February 2008 to February 2009.
- 1.5 The OFT has considered two main potential concerns in the identified relevant markets.

- 1.6 In the first case, in the personal current account, savings and investment product markets, elements of public support such as TPO and deposit guarantees might create a perception among consumers that Northern Rock is 'safer' than other banks. Due to consumer concerns about the stability of banks, consumers might choose Northern Rock because it is the only bank with a 100 per cent deposit guarantee. Northern Rock might be in a position to capitalise on consumer perceptions and expand its market share. There could be further consumer harm arising in the long run when the period of public support ended. Natural customer inertia could set back in and consumers might not switch to other banks which offered better rates. In other words, there might effectively be customer lock-in without the benefit of greater security in the long term.
- 1.7 A review of the available information, coupled with Northern Rock's small shares in the personal current account, savings and investment product markets, suggest that any adverse impacts on competition arising from changed consumer perceptions caused by public support are likely to be minimal or insignificant.
- 1.8 The second potential concern explored by the OFT occurs in the mortgage market. Northern Rock, by virtue of its public support, might be able to take advantage of a lower cost of capital in the money markets to offer lower rates on its mortgages. If Northern Rock's rivals were, or still are, unable to access capital at equivalent costs for the sole reason that they did not receive public support then this distortion may allow Northern Rock to expand its market share. This could lead to an adverse impact on competition that may in turn lead to consumer harm. When public support is withdrawn, and the cost of capital rises, it will be unlikely that such attractive mortgage rates will still be made available by Northern Rock. Consumers may not switch to take advantage of other suppliers and so will end up paying more.
- 1.9 Having reviewed this potential concern, the OFT considers it is unlikely that Northern Rock would be able to use public support as a means to access funding at rates likely to distort competition in the mortgage market.

- 1.10 One of the consequences of public support has been the creation of Northern Rock's provisional Restructuring Plan, published in March 2008. This contained specific targets and commitments to mitigate against any negative consequences on competition (its 'Competitive Framework') and is therefore relevant to both potential concerns outlined above.
- 1.11 It should also be noted that since the granting of public support to Northern Rock there have been significant changes in the financial services sector and public support has been granted to a number of other banks. The Government has also announced a number of measures designed to increase the funding available to SMEs and to support the mortgage market. The instability and change within the sector continues and is likely to reduce the impact on competition of the public support specifically targeted at Northern Rock.
- 1.12 Taken collectively, considering the limited available information, reviewing the application of the Competitive Framework and in the context of wider financial instability, the OFT has concluded that during the review period, public support for Northern Rock did not have a significantly adverse impact on competition.
- 1.13 At the end of February 2009 revisions to Northern Rock's business plan were announced. There has been a change of strategy and instead of decreasing its mortgage book Northern Rock will now increase mortgage lending by up to £14 billion over the next two years. Further announcements will be made once the details of the arrangements are finalised. The changes announced in February have not been implemented yet so are not included in the analysis in this report as they fall outside of the study period. Accordingly, the OFT will continue to monitor developments in the relevant markets to identify any emerging competition concerns.
- 1.14 Given the significant changes in the sector since the commitment to produce an annual report specifically on Northern Rock was made the OFT has agreed with HMT that this approach to the commitment is no longer the most suitable. Going forward the OFT will, as reported in the

Pre Budget Report 2008, publish a Financial Services Strategy in March 2009 (for consultation) followed by a Financial Services Plan later in the year. It is anticipated that work conducted within the Plan will cover both consumer and competition issues across the financial services sector including, where appropriate, consideration of competition issues relating to public support to banks, including where relevant Northern Rock.

2 BACKGROUND

Introduction

- 2.1 In February 2008, during the parliamentary debate on the Banking (Special Provisions) Bill,¹ which resulted in the temporary public ownership (TPO) of Northern Rock,² the Chief Secretary to the Treasury, Yvette Cooper MP, made a commitment that the OFT would 'publish an annual report assessing any competitive implications of the public support for Northern Rock...'³
- 2.2 This report explores competition concerns in the relevant markets arising from the public support of Northern Rock for the period February 2008 to February 2009.⁴
- 2.3 The events in financial markets since 2007 have been explored elsewhere in much more detail.⁵ The purpose of this introductory chapter is to provide a brief background to the issues pertaining directly to Northern Rock and outline the OFT's approach to its competition assessment.

¹ Which received Royal Assent and so became the Banking (Special Provisions) Act 2008 on 21 February 2008.

² By virtue of The Northern Rock plc Transfer Order SI 2008/432, www.opsi.gov.uk/si/si2008/pdf/uksi_20080432_en.pdf, made under powers contained in the Banking (Special Provisions) Act 2008.

³ Reported in Hansard www.publications.parliament.uk/pa/cm200708/cmhansrd/cm080221/debtext/80221-0020.htm#column_629

⁴ This is taken to be the relevant period as it is a year on from when the commitment was made.

⁵ An outline of changes to the financial landscape since September 2008 can be found in Annex C. A more detailed explanation of the events from summer 2007 to October 2008 can be found in Bank of England's Financial Stability Report October 2008. Available at: www.bankofengland.co.uk/publications/fsr/2008/index.htm

Public support for Northern Rock

- 2.4 The 'credit crunch' caused significant turmoil in the banking sector and the wider economy. August 2007 saw the severe rationing of funds in the money markets which led to the mortgage securitisation market effectively seizing up.⁶ Northern Rock was particularly reliant on the wholesale money markets for funding. By the end of 2006, as a proportion of liabilities and equity, 75 per cent of funds came from sources other than retail deposits, primarily wholesale funding.⁷ With the onset of the 'credit crunch' it subsequently began to experience extreme liquidity difficulties, resulting in it being unable to raise money to finance its business. With only a few months of liquidity left Northern Rock contacted the Tripartite Authorities seeking a 'backstop arrangement'.
- 2.5 A leak⁸ revealing the existence of the Bank of England support facility led to a run on Northern Rock's retail deposits⁹ causing the value of its UK retail deposit book to fall from £19 billion at the end of 2006 (out of total reported retail balances of £22.6 billion) to £9 billion at the end of 2007 (total reported retail balances £10.5 billion). This represented a fall of over 50 per cent, as shown in Figure 2.1.

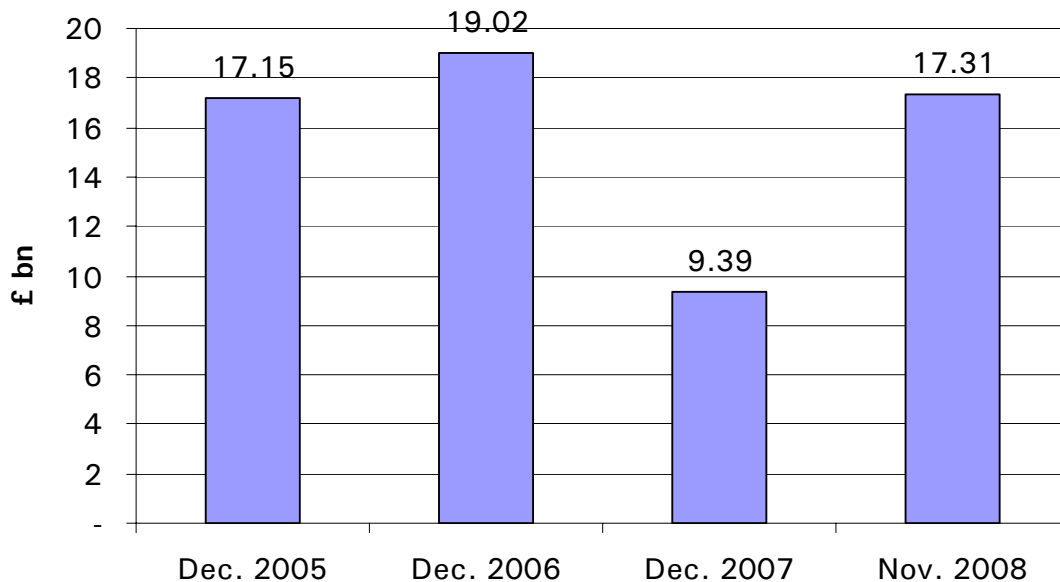
⁶ In June 2007 \$175 billion residential mortgage backed securities (RMBS) were publicly and privately placed, in October 2008 (most recent figures available) \$10 billion RMBS were publicly and privately placed. Source: Chart 2.9, Bank of England, 2008 Financial Stability Report October 2008, Issue No. 24. Available at: www.bankofengland.co.uk/publications/fsr/2008/index.htm

⁷ Paragraph 17, House of Commons Treasury Committee, 2008, *The run on the Rock, fifth report of Session 2007-08*. Available at: www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/5602.htm

⁸ For a fuller description see paragraph 96, House of Commons Treasury Committee, 2008, *The run on the Rock, fifth report of Session 2007-08*.

⁹ Taken to include personal current accounts, savings accounts and investment products.

Figure 2.1: Northern Rock's UK retail deposits, December 2005 to November 2008



Source: Northern Rock

2.6 The run on Northern Rock deposits was the first bank run in the UK for 150 years and was considered by some, including the Tripartite Authorities, to be a genuine threat to the financial stability of the whole economy.¹⁰ Accordingly, between September and December 2007, four forms of public support were granted to Northern Rock in order to stabilise the bank and protect retail depositors:¹¹

- a Bank of England liquidity facility

¹⁰ BBC, 2008, Brown accused of Rock 'dithering', *BBC Online* [internet], 16 January 2008. Available at: news.bbc.co.uk/1/hi/uk_politics/7191689.stm

¹¹ For detailed information about the support given to Northern Rock see House of Commons Treasury Committee, 2008, *The run on the Rock, fifth report of Session 2007-08* and the following Treasury press releases: www.hm-treasury.gov.uk/press_94_07.htm, www.hm-treasury.gov.uk/press_104_07.htm and www.hm-treasury.gov.uk/press_149_07.htm

- a guarantee for all retail deposits held by Northern Rock
- various wholesale guarantee arrangements, and
- additional facilities to support the September liquidity facility.

2.7 In November 2007 the UK Government notified the European Commission (the Commission) of the various support measures that might constitute State aid. The Commission announced that the guarantees were permissible in the short term as rescue aid.¹²

2.8 It should be noted that Northern Rock was granted a waiver of rules regarding the gearing on its regulatory capital resources, but the OFT does not regard this as an independent component of public support.¹³ This is in place until the earlier of either:

- the date on which the government is able to inject further capital to restore Northern Rock's capital resources to a level adequate to comply with regulatory rules, without relying on the waiver, or
- 30 April 2009.¹⁴

¹² Further details can be found at europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1859 and europa.eu/rapid/pressReleasesAction.do?reference=MEMO/07/545&format=HTML&aged=0&language=EN&guiLanguage=en

¹³ Full details are on the FSA Public Register at www.fsa.gov.uk/register/firmRuleWaivers.do?sid=77680

¹⁴ Firms authorised by the FSA are required to maintain adequate financial resources, which includes minimum capital requirements and any amount over and above this minimum that FSA considers is appropriate for a firm to hold (which varies from firm to firm). In these terms, the requirement for Northern Rock reflects the nature of its ownership and the existence of the guarantees but not in a way that requires any formal waiver. This is separate from the requirements relating to the gearing on Northern Rock's capital resources where a waiver does exist, see paragraph 2.8 for more details. If it were the case that some elements of public support were removed (for example, guarantees protecting depositors were released) it would be a reasonable assumption that Northern Rock would have to meet a higher capital requirement.

- 2.9 Upon implementation of the guarantees Northern Rock's management tried, ultimately unsuccessfully, to find a private sector buyer. HM Treasury announced on 17 February 2008 that Northern Rock was being taken into TPO.¹⁵ The Transfer Order laid before Parliament became effective on 22 February 2008.¹⁶
- 2.10 As part of its TPO, Northern Rock drafted a provisional Restructuring Plan which was published in March 2008. This contained a significantly different business strategy compared to its private sector incarnation.¹⁷ The plan set out a 'Competitive Framework' that contained specific targets and commitments to avoid accusations of Northern Rock having an unfair advantage over other banks arising from public support.¹⁸ Further details of the Framework are given in Annexe B, but it is worth noting the following commitments in particular:
- not referring to Government ownership in any marketing literature
 - not allowing its retail deposit balances in the UK to exceed 1.5 per cent market share by value¹⁹

¹⁵ Statement on Northern Rock plc, www.hm-treasury.gov.uk/press_16_08.htm

¹⁶ The Northern Rock plc Transfer Order 2008 SI 2008/432
www.opsi.gov.uk/si/si2008/pdf/uksi_20080432_en.pdf

¹⁷ Arguably for the period 1997-2007, Northern Rock had acted as a challenger in the mortgage market, aggressively competing with traditional banks, to grow its market share on the basis of different product offerings and funding structures. The post-TPO business strategy initially focused much more on stabilisation and consolidation, which entailed significant downsizing. In February 2009 a change in Northern Rock's strategy was announced. Mortgage lending will now be restarted with £5 billion of new mortgage lending in 2009.

¹⁸ See the Provisional Northern Rock Restructuring Plan: Executive Summary 31 March 2008 for more details. Available at:
companyinfo.northernrock.co.uk/downloads/Summary_of_Proposed_Business_Plan.pdf?bcsi_scan_A2018E0826464712=pYz1RBveTmm7I+/NARKlywsAAAAyQMoB&bcsi_scan_filename=Summary_of_Proposed_Business_Plan.pdf

¹⁹ No timeframe is given for this commitment.

- limiting mortgage origination to no more than 2.5 per cent of the market by value per calendar year, and
- not ranking within the top three of any of defined 15 Moneyfacts retail deposit categories for 2008.

2.11 In April 2008²⁰ the European Commission began an in-depth investigation into whether elements of Northern Rock's public support (specifically the retail guarantees, wholesale guarantee arrangements and further liquidity support) were permissible under the restructuring aid guidelines for firms in difficulty. At the time of writing the Commission has received third party comments on its preliminary assessment and is awaiting the revised Restructuring Plan from the UK Government.²¹

Further developments to the public support for Northern Rock since TPO

2.12 As is described in more detail in Annexe C, since the granting of public support for Northern Rock, financial turbulence in markets has continued, affecting a range of market participants and leading the Government to pledge public support for a number of institutions. These developments highlight that Northern Rock has not been the only financial institution to experience difficulties since the onset of the credit crunch. Other, much larger, institutions have also been severely affected by the changes in market conditions. Taken together, these developments mean the UK financial landscape has changed considerably and public support to Northern Rock now only constitutes a very small part of the changes.

²⁰ europa.eu/rapid/pressReleasesAction.do?reference=IP/08/489

²¹ For further details see: eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12002E087:EN:NOT and ec.europa.eu/competition/state_aid/legislation/specific_rules.html

- 2.13 Following the announcement of its investment in a number of major UK banks in October 2008, the Government established UK Financial Investments Ltd (UKFI) in November 2008, a company which will manage all of its shareholdings in these banks. In due course it is intended that UKFI will take over management of the Government's Northern Rock investment.²²
- 2.14 On 19 January 2009, HM Treasury announced that Northern Rock was continuing to work with HM Treasury to review its business plan and strategic options.²³ It was noted that the bank had been able to reduce the Government loan well ahead of the 2009 target in its Restructuring Plan. Reflecting this and wider policy concerns, it was stated that Northern Rock would be slowing down its rate of mortgage redemptions.
- 2.15 A further announcement was made on 23 February 2009. Northern Rock would increase its mortgage lending by up to £14 billion over the next two years.²⁴ The company will be restructured so that the back book of mortgages is managed separately to its other business. The Government also confirmed that, as announced in August 2008, it would be strengthening Northern Rock's capital base by up to £3 billion. Further announcements will be made once the details of the arrangements are finalised. The changes announced in February have not been implemented yet so are not included in the analysis for this report as they fall outside the study period.

The OFT's approach in this report

- 2.16 The scope of and approach taken for this report are a direct reflection of the significant changes in the relevant markets since the commitment to publish a report was made in February 2008. The market upheaval that

²² www.hm-treasury.gov.uk/press_114_08.htm

²³ companyinfo.northernrock.co.uk/corporateCommunications/news/article.asp?newsID=226

²⁴ companyinfo.northernrock.co.uk/corporateCommunications/news/article.asp?newsID=235

occurred after Northern Rock was taken into TPO means that any data from the period of analysis (February 2008 to February 2009) is likely to contain a number of structural breaks²⁵ and will not represent normal market conditions. Notably, the instability and change within the sector continues. As such, the report does not seek to draw out firm conclusions as these would be inappropriate given the lack of reliable and usable data over the period analysed. The OFT will maintain an interest in the impact of public support in banking. The OFT's Financial Services Strategy, to be published later this year, will also consider the relevant markets in banking to assess the nature and timing of further work.

²⁵ A structural break is a structural change detected in a time series sample due to a change in policy or sudden shock to the economy. An example of an event that caused a structural break is the 1987 stock market crash.

3 POTENTIAL CAUSES FOR CONCERN

Introduction

- 3.1 The OFT's focus in this report has been to identify whether public support for Northern Rock has had a significantly adverse impact on competition in the relevant markets arising from its public support during the period February 2008 to February 2009. Due to the period of analysis coinciding with a time of extreme financial turbulence, the analysis presented is brief and by no means exhaustive. The focus of the analysis is on the issues that could have had a significant adverse impact on competition for the period in question.
- 3.2 For the purposes of this analysis, public support is defined by the OFT as consisting of TPO, Bank of England liquidity support, retail guarantees, wholesale guarantee arrangements, and additional liquidity support mechanisms (see paragraph 2.6).
- 3.3 Looking specifically at Northern Rock's portfolio of product offerings,²⁶ this report follows the OFT's analysis of the Lloyds TSB/Halifax Bank of Scotland (HBOS) merger²⁷ and the previously proposed Lloyds TSB/Abbey National merger considered by the OFT and Competition Commission,²⁸ and identifies the following relevant markets:

²⁶ At the time of writing (February 2009), Northern Rock offers personal current accounts; savings and investment products (including fixed rate bonds, e-saving accounts, ISA accounts, charities' accounts, branch, phone and postal savings accounts); and mortgages and secured loans. Northern Rock also offers non-mortgage secured loans to existing mortgage customers linked to the property's equity. Northern Rock has never offered wholesale deposit taking or other corporate banking activities, or other financial services such as pensions or insurance. The report only considers Northern Rock's current activities.

²⁷ Pages 27-29, 53 and 60, OFT, 2008, *Anticipated acquisition by Lloyds TSB plc of HBOS plc.*, Available at: www.oft.gov.uk/shared_of/press_release_attachments/LLloydstsb.pdf

²⁸ Chapter 4, CC, 2001, *Lloyds TSB Group Plc and Abbey National Plc: A report on the proposed merger*. Available at: www.competition-commission.org.uk/rep_pub/reports/2001/fulltext/458c4.pdf

- personal current accounts
- savings accounts
- investment products,²⁹ and
- mortgages.

3.4 The relevant geographic market for all of these is not larger than the UK. The latest market share data for Northern Rock in each of these relevant markets is shown below.

Table 3.1: Northern Rock's UK market shares, October 2008

	Market size, £ million	Number of Northern Rock accounts	Northern Rock market share by value, per cent
Personal current accounts (closing balance)	100,459	Not available	0.2
Savings accounts	514,123	Not available	1.5
Investment products	542,527	Not available	1.4
Mortgages	1,224,001	610,957	5.5 *

* By book size

Source: Northern Rock, Bank of England and OFT calculations

Competition test and causes of concern

3.5 The competition test used by the OFT in this report is whether collectively or individually elements of public support to Northern Rock in the period February 2008 to February 2009 have led to a significantly adverse impact on competition.

²⁹ The OFT has taken investment products to include child trust funds, individual savings accounts (ISAs), National Savings & Investments (NS&I) products, fixed-interest securities, investment bonds, structured products and collective investments. Northern Rock is only active in the provision of ISAs and bonds.

- 3.6 This impact on competition is compared to a **counterfactual**³⁰ of what would have happened in the relevant markets had Northern Rock not received any public support. In this case, the OFT has concluded that the relevant counterfactual is Northern Rock failing and ceasing to be a going concern in the absence of public support.³¹
- 3.7 On the basis of this test, the OFT has identified two possible reasons for concern that public support may have had a significantly adverse impact on competition in the relevant markets.
- First, independent of its actual behaviour, perceptions that public support caused Northern Rock to become a 'safer bank' could have distorted competition in a way that has allowed it, and continues to allow it, to unfairly expand its market share in the personal current account, savings account and investment product markets. This could also potentially lead to a longer term negative impact on competition. Consumer harm could follow if depositors and borrowers, post financial turbulence and public support, through

³⁰ The counterfactual refers to the state of the world if the particular change being analysed had not taken place. See Glossary for more details, more information about the use of counterfactuals can be found in paragraph 3.23, OFT, 2003, *OFT Mergers – Substantive Assessment Guidance*. Available at:

www.offt.gov.uk/shared_offt/business_leaflets/enterprise_act/oft516.pdf

³¹ This accords with the general consensus that had Northern Rock not received its liquidity support, retail deposit guarantees, wholesale arrangements and public ownership, the bank would have ceased to be a going concern. See for example pages 44-45 of *The Run on the Rock*. See also the decision of the Divisional Court in R. (on the application of SRM Global Master Fund LP) v Treasury Commissioners [2009] EWHC 227 (Admin) concerning the claim for judicial review by some former Northern Rock shareholders. They claimed that the legislation relating to the assessment of compensation payable to them as former shareholders of Northern Rock plc following its nationalisation was unlawful as it was to be based on an allegedly flawed assumption that, without public support (which support was not to be taken into consideration in the valuation of compensation payable), Northern Rock was no longer a going concern. The decision in the Divisional Court went against the applicants but they have been given leave to appeal to the Court of Appeal.

inertia are effectively locked-in to products that offer poor rates and do not switch to take advantage of products offering better rates.

- Second, Northern Rock may be able to take advantage of a lower cost of capital as a result of public support to offer better rates in the mortgage market; thereby distorting competition.

3.8 Either of these reasons could in theory lead to the possibility that Northern Rock may have been able to unfairly expand its market share as a result of public support.

Competition may be distorted by perceptions that Northern Rock is a 'safer bank' allowing it to unfairly expand market share

3.9 Two elements of public support may distort competition so as to have allowed Northern Rock to unfairly expand its market share. These elements are:

- its 100 per cent deposit guarantee, and
- consumer perceptions that a Government owned bank is 'safer', especially at a time of turbulence in financial markets.

3.10 These elements apply to the personal current account, savings account and investment product markets.

The deposit guarantees and perceptions

3.11 Unlike other banks, Northern Rock's deposits, whatever their amount, are 100 per cent guaranteed by the Financial Services Compensation

Scheme (FSCS).³² This difference in guarantee amount may have enabled Northern Rock to attract more customers from rival banks.

Table 3.2: Summary of the application of the Financial Services Compensation Scheme guarantee scheme for Northern Rock and other banks, as at February 2009

Application to Northern Rock	Application to all other banks
There is no compensation limit which applies to each depositor for the total of their deposits with Northern Rock, regardless of how many accounts they hold or whether it is a single or joint account. Each account holder in a joint account is eligible for compensation.	There is a compensation limit of £50,000 which applies to each depositor for the total of their deposits with an organisation, regardless of how many accounts they hold or whether they are a single or joint account holder. In the case of a joint account each account holder in a joint account would be eligible for compensation up to the maximum limit.

Source: FSCS, HMT

- 3.12 Similarly, if Government ownership created a perception in customers' minds that Northern Rock is a safer institution than other banks; this may also be construed as an unfair advantage. This would be exacerbated if the parameters of competition have changed from price-based factors to perceptions about supplier security.
- 3.13 A competitive distortion could thus be created if it was only those banks which were perceived as 'safe' (perhaps through public ownership and deposit guarantees) that were able to effectively compete for new

³² The Government has said it would, if necessary, make arrangements to supplement the FSCS. As with other banks, amounts up to £50,000 are covered by FSCS; amounts in excess of the FSCS's £50,000 limit are guaranteed by the Government (www.hm-treasury.gov.uk/press_107_07.htm). For further details see the Financial Services Compensation Scheme, www.fscs.org.uk/consumer/faqs/deposit_claims_faqs/. The FSCS scheme covers deposits, insurance policies, insurance broking (for business on or after 14 January 2005), investment business, and mortgage advice and arranging (for business on or after 31 October 2004).

business. Northern Rock would be in a position to capitalise on consumer perceptions to expand its market share and potentially offer lower benefits, that is, lower interest rates, than would be the case if consumers were not attracted to the bank by the perception of safety.

- 3.14 There could be further consumer harm arising from any competitive distortion in the long run when financial turbulence ceases and public support is withdrawn. This harm would arise if natural customer inertia sets back in and consumers do not to switch their accounts to other banks which offer better rates.³³ In other words, there might effectively be customer lock-in without the benefit of greater security. In this sense, public support could provide Northern Rock with an 'unfair advantage' today that has a negative long term impact on competition.
- 3.15 Having reviewed the available information, the OFT does not believe that the 100 per cent deposit guarantee had any significantly adverse impact in any of the relevant markets for the period February 2008 to February 2009. This is for a number of reasons.
- 3.16 In the first instance, it is not obvious that depositors with Northern Rock do enjoy greater protection than depositors with other banks. As the examples of London Scottish Bank and two UK branches of Icelandic banks demonstrated, the Government effectively stepped in to protect all deposits, including those with balances above £50,000.³⁴
- 3.17 Internal research commissioned by Northern Rock and received by the Company in January 2009, suggests that, along with interest rates and transparency, consumers with savings and investment products³⁵ were

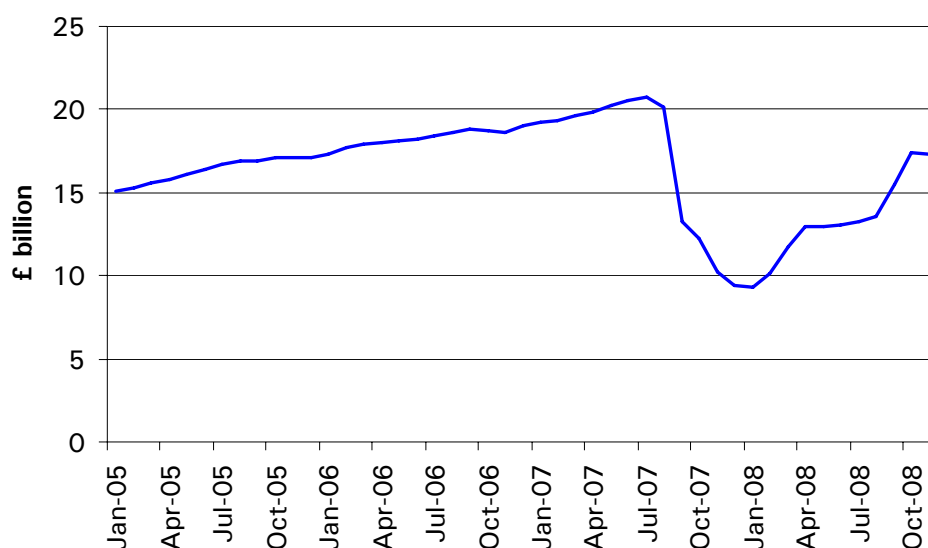
³³ The OFT PCA Market Study examined issues of switching and inertia extensively. Chapter 5, OFT, 2008, *Personal current accounts in the UK*. Available at: www.oft.gov.uk/shared_oftrreports/financial_products/OFT1005.pdf

³⁴ For more details see www.hm-treasury.gov.uk/press_129_08.htm and www.hm-treasury.gov.uk/press_101_08.htm.

³⁵ Savings and investment products are taken to include: instant access savings accounts, high interest/regular savings accounts, over 50's accounts, ISAs and fixed rate bonds.

placing solidity (being safe/secure) near the top of their concerns when choosing a supplier.³⁶ This suggests that consumers may be attracted to a bank that is perceived as 'safest'. However, the information on savings and investment flows reviewed does not indicate any significantly adverse impact on competition in the relevant markets for the period February 2009 to February 2009. This is because, while the graph below shows Northern Rock's retail deposits growing, its market share for all retail deposits remains very small (see Table 3.4).

Figure 3.3: Northern Rock's personal current accounts, savings and investment products, UK, January 2005 to November 2008³⁷



Source: Northern Rock

³⁶ This coincides with earlier research in 2008 by Mintel on ISAs, (Mintel, 2008, *ISAs, Finance Intelligence*) which found that Northern Rock had the lowest trust ratings compared to other ISA providers such as Nationwide and National Savings and Investment.

³⁷ Note: the values used in Figure 3.3 do not exactly equate to those used in Table 3.1. This arises because of variations used in definitions by Northern Rock and the Bank of England.

3.18 The corresponding market shares are tabulated below and do not suggest the 100 per cent guarantee for deposits and any changed consumer perceptions are likely to lead to a significantly adverse impact on competition at present. The OFT's view is that, compared to the counterfactual of Northern Rock ceasing to be a going concern, there is no significant distortion to competition.

Table 3.4: Northern Rock's market share in the retail deposit market (personal current accounts, savings and investment products), UK, by value, per cent

	December 2005	December 2006	December 2007	November 2008
Market share, per cent	1.8	1.8	0.8	1.5

Source: Northern Rock

3.19 Further, it is worth remembering that, as required by the Competitive Framework, Northern Rock's market share in the personal current account, savings and investment product markets cannot collectively exceed 1.5 per cent by value. HM Treasury monitor this Framework, reviewing daily, weekly, monthly and ad hoc data to ensure the Framework is adhered to. If the Framework were breached, then HM Treasury would seek to remedy the situation. During the latter half of 2008, when deposits were increasing (see Figure 3.3 and Table 3.5), Northern Rock took appropriate action to avoid breaching the Framework, for example it reduced its rates and withdrew some of its advertising campaigns.

3.20 Northern Rock is adhering to the Competitive Framework by not referring to its ownership by Government in its promotional material.³⁸

³⁸ However, given the novelty of the bank's situation at that time, it is likely that most consumers are aware of its ownership.

- 3.21 Looking at the relevant markets individually, it can be seen that Northern Rock's market shares remain below 1.5 per cent in each relevant market, although this limit has been reached in certain markets.

Table 3.5: Northern Rock's market shares in the relevant markets, per cent

	Dec 07	Jan 08	Feb 08	Mar 08	Apr 08	May 08	Jun 08	Jul 08	Aug 08	Sep 08	Oct 08
Personal current accounts	0.18	0.17	0.17	0.17	0.17	0.17	0.17	0.16	0.16	0.17	0.19
Savings accounts	0.67	0.63	0.66	0.87	1.02	1.01	1.02	1.03	1.04	1.19	1.48
Investment products	0.92	0.96	1.03	1.12	1.19	1.18	1.20	1.23	1.26	1.50	1.44

Source: Northern Rock, Bank of England and OFT calculations

- 3.22 Nonetheless, for the reasons outlined above, compared to the counterfactual of Northern Rock ceasing to be a going concern, it is unlikely that there is any significant distortion to competition being caused by these market shares – which are collectively capped at a level unlikely to raise concerns.
- 3.23 The rise in the market shares for savings accounts and investment products in the September and October 2008 was likely to have been a reaction to the wider financial turbulence taking place at the time. In September 2008 the collapse of Lehman Brothers caused a large scale disturbance in financial markets and the data suggests that many consumers reacted to this uncertainty by moving their money to Northern Rock which they regarded as 'safe'. In line with the continued financial instability the inflow into Northern Rock continued in October 2008.
- 3.24 Figure 3.6 shows that during September and October 2008 Northern Rock experienced a large net inflow into its saving and investment accounts. Northern Rock's target market shares were reached in investment products in September 2008 and nearly reached in savings

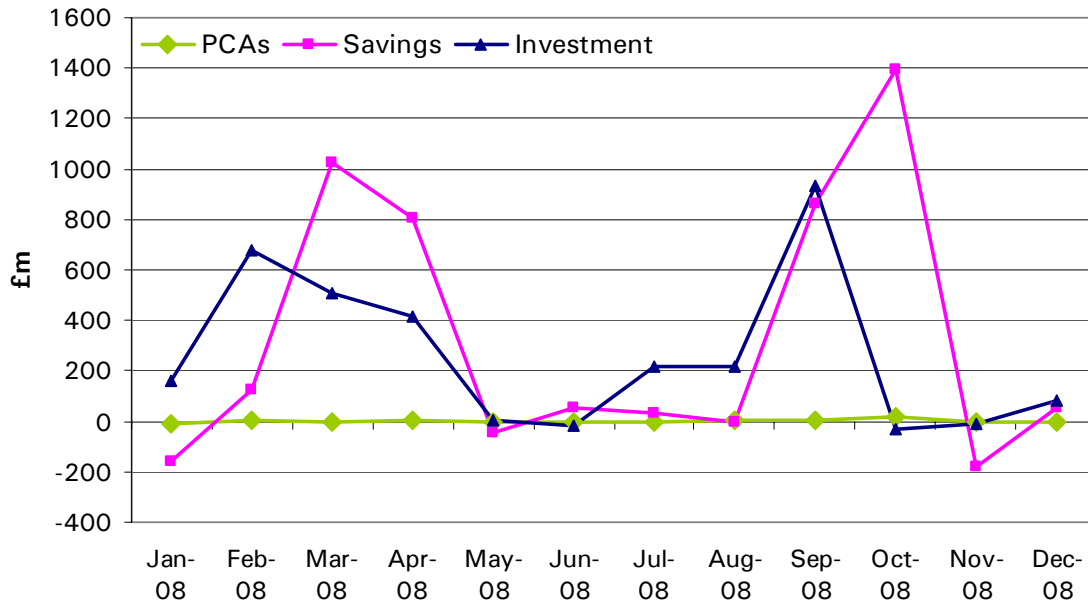
products in October 2008. As detailed in paragraph 3.19 Northern Rock took measures to ensure that the 1.5 per cent limit was not breached.

- 3.25 Figure 3.6 shows that in November and December 2008 the large inflows into Northern Rock stopped. It seems feasible that the combination of public support for other banks³⁹ and a change in Northern Rock's product offering to comply with the Competitive Framework made Northern Rock less attractive to consumers than it had been in September and October 2008.⁴⁰

³⁹ Government announced the public support of RBS and the merged Lloyds HBOS through the bank recapitalisation plan in October 2008, see www.hm-treasury.gov.uk/press_100_08.htm, www.hm-treasury.gov.uk/press_105_08.htm and www.hm-treasury.gov.uk/press_106_08.htm

⁴⁰ The most recent data the OFT had access to was December 2008 so it is impossible to draw a definite conclusion or know whether this stability has continued.

Figure 3.6: Net move in Northern Rock personal current accounts, savings accounts and investment products, January 2008 to December 2008, £m



Where savings accounts include the follow Northern Rock products: Silver Online, Tracker Online, E-Saver and Silver accounts. Investment products include fixed rate bonds, fixed rate ISAs and 30 Day ISAs.

Source: Northern Rock

3.26 Related to this, changes to the financial landscape may imply that there are two impacts going in opposite directions. On the one hand, worsening financial conditions may have led a greater number of customers to switch to Northern Rock following public support. On the other hand, customers may have switched to Lloyds Banking Group and RBSG following the Government's investments in them. If consumers do value security arising from Government ownership,⁴¹ it is plausible that

⁴¹ As suggested by research commissioned by Northern Rock on its saving and borrowing customers in late 2008.

they will shift to these banks which are unconstrained in terms of the amount of deposits they can take.⁴² Combined with the measures taken in January 2009 by Government to secure the entire banking sector, any competitive advantage Northern Rock might have derived from its public support between February 2008 and February 2009 is likely to now be severely diluted.

- 3.27 Lastly, for depositors with more than £50,000, the same level of protection is available if they split their deposits across multiple institutions. The benefits of having this amount of money in a single institution would appear to be marginal.⁴³
- 3.28 To conclude, based on the limited information, the OFT does not believe, relative to the counterfactual, the elements of public support for Northern Rock for the period in question have caused a significant, adverse impact on competition.

Northern Rock may be able to take advantage of a lower cost of capital to increase market share

- 3.29 While the information suggests that the 100 per cent guarantee and consumer perceptions may not be having a significantly adverse impact on competition, it may be the case that public support allows Northern Rock to take advantage of a lower cost of capital and distort competition by being able to offer lower rates in the mortgage market. If Northern Rock's rivals were, or still are, unable to access capital at equivalent costs not for efficiency reasons, but for reasons of public support, then

⁴² In contrast to the constraint placed on Northern Rock by its Competitive Framework.

⁴³ Chart 5.2 of the Tripartite Authorities January 2008 consultation document, *Financial stability and depositor protection: strengthening the framework*, showed the overwhelming majority of UK deposit accounts held less than £35,000. Available at: www.hm-treasury.gov.uk/financial_stability_framework.htm

this distortion may allow Northern Rock to expand its market share.⁴⁴ A rise in market share could lead to an adverse impact on competition that may in turn lead to consumer harm. When public support is withdrawn, and the cost of capital rises, it will be unlikely that such attractive rates will still be available and consumers may not switch to take advantage of other suppliers. Given Northern Rock's potentially sizeable market share in the mortgage market, this impact could be significant.

3.30 There is very limited information to test whether public support is having such an impact. However, on balance, the OFT does not believe that public support for Northern Rock had any significantly adverse impact on competition between February 2008 and February 2009 arising from the lines discussed above. This is for the following reasons:

- In the first instance, given the well documented closure of wholesale markets, even if Northern Rock were to have a lower cost of capital relative to its competitors, it would not be able to exploit this and offer better rates or a larger product range.
- The link between a lower cost of capital and cheaper/wider product offerings is not clear. The cost of capital is likely to be only one of many contributing determinants to setting prices/range in the relevant markets.
- In the case of mortgages, while the OFT has noted the potential for rising switching costs in a period of financial instability,⁴⁵ it does not seem likely that Northern Rock will be able to use its public support to increase consumer lock-in. These higher switching costs will reduce the level of switching in the counterfactual given wider market trends.

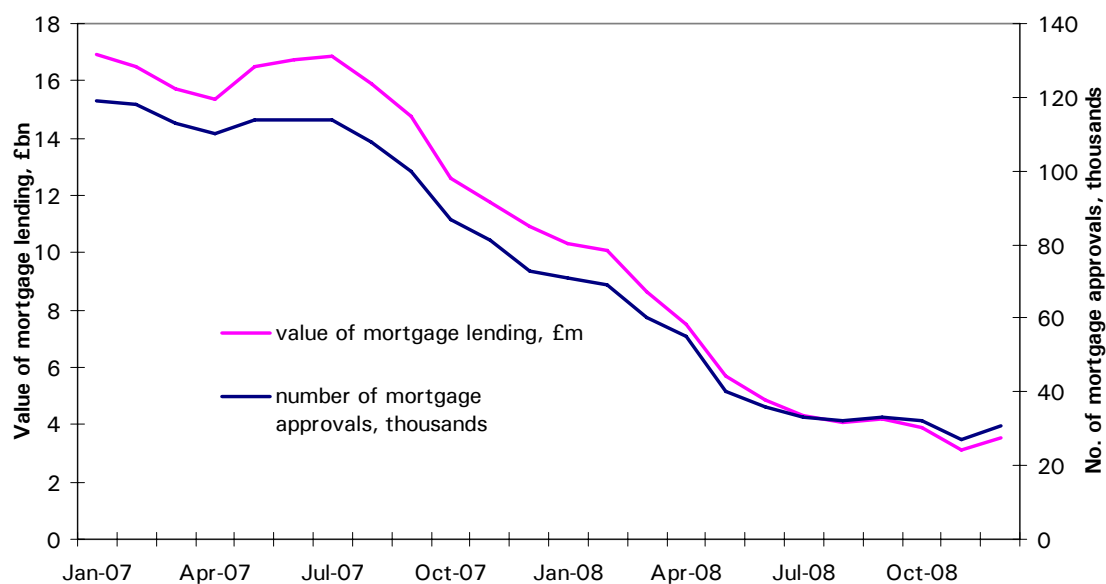
⁴⁴ Cheaper access to capital might be available to Northern Rock if the market were to perceive it as a safer institution. It would then get a higher credit rating relative to other banks, which would allow it to borrow more cheaply and advance more loans.

⁴⁵ Paragraph 191, OFT, 2008, *Anticipated acquisition by Lloyds TSB plc of HBOS plc*. Available at: www.of.gov.uk/shared_of/press_release_attachments/LLloydtsb.pdf

- further, it should be recalled that Northern Rock in the mortgage market is also subject to the conditions set out in the Competitive Framework.

3.31 Indeed, with respect to the final point it should be noted that Northern Rock's mortgage book has also dramatically reduced since September 2007, although plans are to increase it again over the next two years.

Figure 3.7: Northern Rock's mortgage book, January 2007 to November 2008



Source: Northern Rock

3.32 This recent reduction in mortgage lending is reflected in market shares measured either as total mortgages outstanding or new lending.

Table 3.8: Northern Rock's market shares in mortgages, December 2007 to November 2008, per cent

	Dec 07	Jan 08	Feb 08	Mar 08	Apr 08	May 08	Jun 08	Jul 08	Aug 08	Sep 08	Oct 08	Nov 08
Mortgage market share of balances, per cent of market value	7.5	7.2	7.1	6.9	6.7	6.5	6.3	6.1	5.9	5.8	5.6	5.5
Mortgage market share of new mortgage lending, per cent of cumulative new lending	8.1	2.1	1.8	1.6	1.4	1.3	1.2	1.2	1.1	1.1	1.1	1.1

Source: Northern Rock

3.33 Thus, based on the limited information, the OFT does not believe, relative to the counterfactual, public support for Northern Rock has allowed it to distort competition by exploiting a lower cost of capital to expand market share.

4 CONCLUSION

- 4.1 There are two main factors that prevent the OFT from drawing any definitive conclusions in this report.
- First, the limited nature of the information and the fact that the data available are likely to contain a number of structural breaks and not represent normal market conditions.
 - Second, since Northern Rock was taken into TPO, the market has changed considerably, and many of the initial concerns about the competitive impact of public support for Northern Rock must now be seen in a wider context of very significant public support for the whole banking market.
- 4.2 Further, following a public announcement on 23 February Northern Rock is to increase its mortgage lending over the next two years. This increase in lending will be up to £14 billion with £5 billion being lent during 2009. It is likely that this increase in lending will have an impact on the mortgage market which will need to be monitored.
- 4.3 The OFT has used a competition test that considers whether elements of public support in place for the period February 2008 to February 2009 (individually or collectively) had a significantly adverse impact on competition in the relevant markets during that period. The OFT has compared this to a counterfactual of what would have happened in the relevant markets had Northern Rock not received any public support. In this case, the appropriate counterfactual is Northern Rock ceasing to be a going concern.
- 4.4 On the basis of the available information, a review of the application of the Competitive Framework and taking account of the context of wider financial instability, the OFT has found that public support for Northern Rock did not have a significantly adverse impact on competition during the review period.

- 4.5 However given the announcement that Northern Rock will restart mortgage lending in 2009-10 the impact of the public support for Northern Rock may be more significant in the future.
- 4.6 Finally, it should be noted that in most cases any study of a single market player is likely to only give a partial picture. Given the significant changes in the sector since the commitment to produce an annual report specifically on Northern Rock was made the OFT has agreed with HMT that this approach to the commitment is no longer the most suitable. Going forward the OFT will, as reported in the Pre Budget Report 2008, publish a Financial Services Strategy in March 2009 (for consultation) followed by a Financial Services Plan later in the year. It is anticipated that work conducted within the Plan will cover both consumer and competition issues across the financial services sector including, where appropriate, consideration of competition issues relating to public support to banks, including where relevant Northern Rock.

A GLOSSARY

CC Competition Commission

Collateral In financial terms collateral is the asset belonging to the borrower which is pledged to the lender as security for a loan. For example a dwelling is the collateral for a mortgage. In the event of a default on the loan, the lender may be able to exercise rights over the collateral as recompense.

Competitive Framework The Competitive Framework is unique to Northern Rock and sets parameters on its behaviour in relation to certain markets. More detail can be found in Annexe B.

Counterfactual The Counterfactual is a concept of economic theory and refers to the situation of what would have happened in the sector if the particular change being analysed did not take place. It focuses on the root causes of the change, not the impact, because the same impact can be caused by different root causes. A well-defined counterfactual can thus be used as a baseline to measure the impact on competition arising from a particular change

Covered bonds Covered bonds are debt instruments secured by a pool of mortgage loans or public-sector debt (known as a 'cover pool') to which investors have a preferential claim in the event of default. The nature of this preferential claim, as well as other safety features (asset eligibility and coverage, bankruptcy-remoteness and regulation) depends on the specific framework under which a covered bond is issued.

Credit crunch A large-scale reduction in the general availability of loans (or credit) or a sudden tightening of the conditions required to obtain a loan from lenders.

Debt instrument A formal, written undertaking, issued by a borrower, acknowledging a given debt and various aspects of it, including: the level and timing of interest payments and date(s) of redemption. Debt instruments can be bought and sold and the benefits are payable to whoever is the registered owner at the time the benefit occurs.

Demutualisation The process by which building societies and mutual insurers convert themselves from mutual organisations (owned by their members/customers) to profit-making companies which distribute profits to their shareholders.

FSA Financial Services Authority

FSCS Financial Services Compensation Scheme

HMT HM Treasury

Liquidity Liquidity refers to the ability of an asset to be bought or sold without causing a substantial movement in price and with a minimum loss of value. The most liquid asset is cash.

Liquidity support to Northern Rock The Bank of England agreed to lend to Northern Rock (at a premium interest rate) on the basis of certain collateral to cover its short-term funding crisis. Additional uncommitted facilities were also provided, that is they were not subject to any borrowing limit. Any money borrowed would be repayable on demand and subject to an interest premium paid to HM Treasury.

Mortgage A mortgage is a type of secured lending where the loan is secured against real property.

OFT Office of Fair Trading

Personal current account An account, for individuals not businesses, which provides the facility to hold deposits, receive and make payments (cheque and debit cards), use ATM facilities and make regular payments (direct debits and standing orders).

Public support for Northern Rock Public support for Northern Rock is: Temporary Public Ownership, Bank of England liquidity support, retail guarantees, wholesale guarantee arrangements, and additional liquidity support mechanisms.

Relevant markets The relevant market refers to the markets which an undertaking operates in. The determination of relevant markets helps to build the market definition and is used to help assess competition.

Restructuring aid State aid granted to a firm once a restructuring or liquidation plan has been established and is being implemented, to restore a firm's long term viability. For more information see the Commission's guidance on rescue and restructuring aid eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:244:0002:0017:EN:PDF

Retail deposits Deposits made by individual consumers into personal current accounts, savings account and investment products

Retail guarantees to Northern Rock All retail deposits in Northern Rock are fully guaranteed. This guarantee covers future interest payments, movements of funds between existing accounts, and new deposits into existing accounts. This is in contrast to the limit to the compensation payable under the FSCS.

Savings account An account available to individual consumers. It usually offers a higher interest rate than a personal current account but with fewer facilities. For example, most savings accounts do not have the facility to receive and make payments (using cheques and debit cards) or make regular payments (direct debits and standing orders).

Secured lending Lending that is secured against an asset (the asset is also known as collateral) over which asset the lender can exercise rights in the event of borrower default, mortgages are an example of secured lending.

Securitisation The process which involves combining and repackaging income producing assets into securities that are then sold to investors. In a securitisation the assets are typically transferred to a separate legal entity (sometimes known as a special purpose vehicle (SPV), which sells the securities (backed by those assets) to investors.

Special purpose vehicle (SPV) A special purpose vehicle (SPV), or special purpose entity (SPE), is a legal entity (for example a limited company or a trust) that is created solely for a particular financial transaction or series of transactions. If the SPV is, as they typically are designed to be, at arm's length from the originator of the assets (for example, the mortgage lender) that are subsequently securitised, the transfer of the assets counts as a sale. This means that the original owner is allowed to remove the assets, and the debt associated with those assets, from its balance sheet. The risk associated with those assets (in particular the risk of the anticipated revenue stream derived from the assets

underperforming) is also transferred from the originator of the assets to the investors purchasing the securities (backed by those assets) from the SPV.

State aid Broadly, a government's financial aid which favours selected businesses. Article 87(1) of the Treaty of Rome provides that unless otherwise permitted by the Treaty, State aid, in any form, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods is, insofar as it affects trade between Member States, incompatible with the common market and, consequently, unlawful.

Structural break A structural break is a structural change detected in a time series sample due to a change in policy or sudden shock to the economy. An example of an event that caused a structural break is the 1987 stock market crash.

TPO Temporary public ownership

Tripartite Authorities The Tripartite is made up of the Bank of England, the Financial Services Authority and HM Treasury.

Unsecured lending Loans where no collateral is provided to protect the lender against the risk of default. Examples of unsecured lending include credit cards and overdrafts.

Wholesale arrangements to Northern Rock The guarantee of wholesale deposits and borrowing. See Annexe D for more details.

Wholesale financial markets Markets (both national and international) only available to those dealing in large quantities. These markets are dominated by interbank transactions, though participants include general insurers and reinsurers, investment firms and banks. There are a number of wholesale markets, defined by the products traded, including: money markets (to fund short term borrowing and lending), bond (or fixed income) markets (for longer term funding) and foreign exchange markets.

B NORTHERN ROCK'S COMPETITIVE FRAMEWORK

- B.1 On 31 March 2008, Northern Rock published its provisional Restructuring Plan. The Plan sets out four strategic priorities:
- repay the loans provided by the Bank of England
 - align the organisation and operation of Northern Rock under new management via downsizing and reshaping
 - build a stand-alone funding and capital position, and
 - strengthen the risk and control environment.
- B.2 The plan acknowledges that Northern Rock cannot take advantage of the support facilities it receives from Government during its public ownership in such a way that distorts competition. Accordingly, it creates a 'Competitive Framework' which seeks to reassure stakeholders and other market participants that it will not use its Government support to compete unfairly.
- B.3 This framework consists of a set of principles and more concrete indicators. At a high level, Northern Rock commits not to promote any Government guarantees, not to sustain a prolonged presence as a market leader in any market, to maintain market shares below historic averages (while in receipt of State aid) and to differentiate itself via service and innovation.
- B.4 The more specific commitments include:
- not explicitly referring to Government ownership in marketing literature
 - not allowing its share of the retail deposit market in the UK to exceed 1.5 per cent and 0.9 per cent in Ireland
 - limiting its share of new mortgage origination to no more than 2.5 per cent in any calendar year, and
 - not ranking within the top 3 in any one of the defined Moneyfacts retail deposit categories for the remainder of 2008.

C CHANGES TO THE FINANCIAL LANDSCAPE

Summary of main changes to Northern Rock

C.1 The table below summarises the main changes affecting Northern Rock since September 2007.

Table C.1: Northern Rock chronology

14 September 2007	<p>Announcement by Chancellor of liquidity support facility at Bank of England for Northern Rock:</p> <p>The Governor of the Bank of England and the chairman of the FSA advised the Chancellor that the position of Northern Rock Plc, given market conditions at that time, constituted a genuine threat to the stability of the UK financial system.</p>
17 September 2007	Announcement by Chancellor of arrangements to guarantee existing deposits in Northern Rock.
20 September 2007	Announcement to markets clarifying arrangements to guarantee deposits in Northern Rock.
21 September 2007	Announcement to markets on extension of guarantee arrangements of deposits in Northern Rock.
9 October 2007	Announcement to markets on extension of guarantee of deposits in Northern Rock arrangements and new facilities at Bank of England for Northern Rock.
19 November 2007	Principles for assessing proposals for Northern Rock's future published by Treasury on behalf of Tripartite Authorities.
18 December 2007	Announcement to markets of extension of wholesale guarantee arrangements.
21 January 2008	Details of a new financing structure that could be made available to Northern Rock and other interested parties, for a possible private sector solution for the entire company published by Treasury on behalf of the Tripartite.

17 February 2008	Government decided to bring forward legislation that will enable Northern Rock plc to be taken into a period of temporary public ownership after full consultation with the Bank of England and the Financial Services Authority.
21 February 2008	<p>The Banking (Special Provisions) Bill 2008 received Royal Assent and became an Act.</p> <p>The Northern Rock plc Compensation Scheme Order laid before Parliament.</p> <p>The Northern Rock plc Transfer Order laid before Parliament (became effective on 22 February 2008).</p>
12 March 2008	The Northern Rock plc Compensation Scheme Order 2008 is made.
31 March 2008	<p>Written Ministerial Statement by Chancellor:</p> <p>'...The Board of Northern Rock plc has today published its annual report and accounts for 2007. These show that the Bank of England loan facilities to Northern Rock plc as at 31 December 2007 stood at £26.9bn. Since then some £2.5bn has been repaid and the gross loan stands at around £24bn. These accounts also demonstrate that Northern Rock remains solvent and meets its regulatory requirements.'</p> <p>'The Board of Northern Rock has also published a more detailed business plan, which I have approved... Furthermore Northern Rock has published as part of its business plan a Competitive Framework, which is subject to European Commission approval, setting out its commitment not to take unfair advantage of Government support during the State aid period... I have also agreed with Northern Rock a shareholder agreement that sets out the Framework within which HM Treasury will operate its shareholder relationship with Northern Rock...'⁴⁶</p>

⁴⁶ Reported in Hansard

www.publications.parliament.uk/pa/cm200708/cmhansrd/cm080331/wmstext/80331m0001.htm#column_27

5 June 2008	Applications invited for appointment as independent valuer for the Northern Rock plc Compensation Scheme.
5 August 2008	Announcement that Government is committed to reinforcing Northern Rock's capital base through a debt-to-equity swap of up to £3bn if required. Publication of Northern Rock's half-year results for 2008.
8 September 2008	Andrew Caldwell appointed as independent valuer to decide level of any shareholder compensation under the Northern Rock plc Compensation Scheme.
3 November 2008	Announcement by Chancellor of arrangements for managing the Government's shareholding in banks subscribing to its recapitalisation fund.
20 November 2008	Announcement by Northern Rock to markets of 'non-asset trigger' event causing Granite to go into 'rapid amortisation' or 'pass-through'.
3 December 2008	Northern Rock announcement on repossession policy: 'Northern Rock confirms that as part of its ongoing commitment to working with customers who are experiencing mortgage repayment difficulties, it will formalise its policy and not take repossession of an owner-occupied property for at least six months after the customer first falls into arrears.' ⁴⁷ Announcement of Government scheme to help people at risk of repossession. The 8 largest lenders in UK mortgage market – including Northern Rock - agreed to support the scheme.
13 January 2009	Judicial Review hearing commenced regarding claims made by

⁴⁷ companyinfo.northernrock.co.uk/corporateCommunications/news/article.asp?newsID=216

	former Northern Rock shareholders against HMT.
19 January 2009	Government announcement that '...Northern Rock is no longer actively pursuing a policy of rapidly reducing its existing mortgage book.' ⁴⁸
13 February 2009	Former Northern Rock shareholders lose their legal challenge against HMT. Permission has been given for an appeal to the Court of Appeal. At the time of writing it is not known whether or not an appeal will be pursued.
23 February 2009	Announcement of change to Northern Rock's strategy: 'Northern Rock will increase mortgage lending by up to £14 billion over the next two years in plans announced today. A new business strategy has been agreed that will see around £5 billion of new mortgage lending for 2009 and between £3 and £9 billion from 2010 onwards, subject to market demand.' '... To enable Northern Rock to focus on new lending, the company will be restructured so that the back book of mortgages is managed separately to its other business. The restructuring will be implemented subsequent to state aid approval.' ⁴⁹

Overview of main changes to the financial services sector

C.2 Between September 2008 and February 2009, the market witnessed a number of major events such as the demise of a major bank, Lehman Brothers, and the emergency acquisition of a number of others (such as the acquisition of Merrill Lynch by Bank of America and the acquisition of Wachovia by the Wells Fargo bank group). The turbulence was not

⁴⁸ www.hm-treasury.gov.uk/press_05_09.htm

⁴⁹ www.hm-treasury.gov.uk/press_15_09.htm

limited to the banking sector, as assistance to the distressed insurer AIG showed.⁵⁰

- C.3 This annexe briefly highlights those changes in the UK that are most relevant to the analysis contained in this report.
- C.4 In the UK, one of the most important changes to the financial landscape was the investment by the Government in the Lloyds Banking Group and the Royal Bank of Scotland Group (RBSG).⁵¹ The Government also nationalised Bradford and Bingley following its collapse, with the onward transfer of its branch network and savings business which was sold to Abbey National plc, part of the Banco Santander Group.⁵² Bradford & Bingley's mortgage book remains in public ownership and will be run off over time. At the time of writing, Government owns significant shareholdings in the Lloyds Banking Group and RBSG and wholly owns Bradford and Bingley's mortgage book, as well as Northern Rock.
- C.5 Additional changes include:
- the acquisition of Alliance and Leicester by Banco Santander Group
 - the acquisition of the Cheshire and Derbyshire building societies by Nationwide building society, and
 - the Britannia building society merging with Co-operative Financial Services.
- C.6 In addition to changes in the structure of the banking sector the Government has also announced a number of public support measures. These include:

⁵⁰ On 17 September 2008, the US Government announced an US\$86 billion package to rescue the insurer. news.bbc.co.uk/1/hi/business/7620127.stm

⁵¹ The merger of Lloyds TSB and Halifax Bank of Scotland (HBOS) itself occurred during the financial turbulence and was a direct response to it.

⁵² www.hm-treasury.gov.uk/press_97_08.htm

- The extension of FSCS depositor scheme. Before 1 October 2007, the maximum level of compensation available was £31,700 (100 per cent of the first £2,000 and 90 per cent of the next £33,000), this was extended on 1 October 2007 to a maximum level of compensation of £35,000 and with effect from 7 October 2008 this limit was increased again to £50,000.⁵³
- A Government bank recapitalisation scheme which resulted in £37 billion capital investment in RBS and the merged Lloyds TSB and HBOS.⁵⁴
- Revisions to the Government's Credit Guarantee Scheme. These revisions included a reduction in fees paid by participating institutions and an extension of the scheme until April 2014.⁵⁵
- A package of measures to help support lending in the economy. These measures included a capital and asset protection scheme for banks, wholesale guarantees and insurance.⁵⁶

C.7 These developments highlight that Northern Rock was not the only financial institution to experience difficulties since the onset of the 'credit crunch'. Taken together, they mean the UK financial landscape has changed considerably and the public support to Northern Rock only constitutes a small part of the changes.

⁵³ www.fscs.org.uk

⁵⁴ www.hm-treasury.gov.uk/press_100_08.htm, www.hm-treasury.gov.uk/press_105_08.htm and www.hm-treasury.gov.uk/press_106_08.htm

⁵⁵ www.hm-treasury.gov.uk/press_138_08.htm

⁵⁶ www.hm-treasury.gov.uk/press_05_09.htm

D PUBLIC SUPPORT FOR NORTHERN ROCK

- D.1 In addition to TPO, Northern Rock is also in receipt of the following public support measures.

Bank of England liquidity support facility

- D.2 This was granted on 14 September 2007 and refers to a facility granted by a bank to meet the short-term funding requirement of another bank. In this case, the Bank of England agreed to lend to Northern Rock (at a premium interest rate) on the basis of certain collateral to cover its short-term funding crisis.⁵⁷ For a number of reasons, but in particular, because the facility entailed an interest premium (that is, in excess of the market rate) and no Government indemnity, the Commission later concluded that this did not constitute State aid.⁵⁸
- D.3 In a press release issued the same day, the Bank of England noted that the 'liquidity facility will be available to help Northern Rock to fund its operations during the current period of turbulence in financial markets while Northern Rock works to secure an orderly resolution to its current liquidity problems'.⁵⁹

Retail Guarantees

- D.4 When news of the Bank of England's facility for Northern Rock became public, Northern Rock experienced a 'run on the bank' whereby its customers sought to withdraw their deposits.

⁵⁷ In its role as lender of last resort, the Bank of England confirmed it was ready to make available similar facilities in comparable circumstances to other institutions which faced short-term liquidity difficulties.

⁵⁸ For some frequently asked questions on the Commission's approval, see europa.eu/rapid/pressReleasesAction.do?reference=MEMO/07/545

⁵⁹ *Liquidity Support for Northern Rock plc*, Bank of England press release, 14 September 2007, www.bankofengland.co.uk/publications/news/2007/090.htm

- D.5 The run on deposits which took place between 14 September and 17 September 2007 meant that the liquidity facility, which had originally been envisaged as a mere 'backstop' was called upon almost immediately.
- D.6 Factors that may have influenced the run were:
- the public perception that Northern Rock was in a precarious state and could collapse. This in turn led to depositors rushing to withdraw their deposits, causing panic, and
 - if Northern Rock were to collapse only the first £2,000 of their savings were fully guaranteed under the existing Financial Services Compensation Scheme.⁶⁰
- D.7 In an attempt to arrest the 'run on the Rock', the Chancellor of the Exchequer announced on 17 September that
- '...because of the importance I place on maintaining a stable banking system and public confidence in it, I can announce today that following discussions with the Governor and the Chairman of the FSA, should it be necessary, we, with the Bank of England, would put in place arrangements that would guarantee all the existing deposits in Northern Rock during the current instability in the financial markets. This means that people can continue to take their money out of Northern Rock. But if they choose to leave their money in Northern Rock, it will be guaranteed safe and secure'.⁶¹
- D.8 More details regarding these deposit guarantees were provided in a later press release:⁶²

⁶⁰ At the time, 100 per cent of the first £2,000 was guaranteed and 90 per cent of the next £33,000. This subsequently changed.

⁶¹ *Statement by the Chancellor of the Exchequer on financial markets*, HMT press release, 17 September 2007, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_95_07.cfm

⁶² *Northern Rock plc deposits*, HMT press release, 20 September 2007, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_96_07.cfm

- all existing retail deposits as at midnight 19 September 2007 would be fully guaranteed fully, that is, beyond £35,000
- the guarantee would cover future interest payments, movements of funds between existing accounts and new deposits in existing accounts
- the guarantee would also cover accounts re-opened in the future by those who closed them between 13 September and 19 September inclusive, and
- any new accounts opened after 19 September 2007 would be subject to the normal arrangements so as not to act as an unfair advantage to Northern Rock.

D.9 These retail guarantees were further extended on 9 October 2007. In particular, at the request of Northern Rock, HM Treasury extended the 100 per cent cover of deposits to include new retail accounts opened with the bank from the date of original guarantees (19 September).⁶³

D.10 As part of this arrangement, it was made clear that Northern Rock would be liable for a fee for this privilege (payable to HM Treasury). The fee was said to be set at a higher rate than the interest premium on the additional Bank of England facilities also arranged on 9 October (see paragraph D.15).

D.11 It was noted that HM Treasury would give at least three months notice before it ended these guarantees.

Wholesale guarantees

D.12 At the same time as providing for the initial retail guarantees (19 September), HM Treasury confirmed it was providing arrangements which would cover wholesale deposits. In particular, the arrangements would cover existing and renewed wholesale deposits and existing and renewed wholesale borrowing that is not collateralised.

⁶³ At the same time, the arrangements of the Financial Compensation Scheme were changed so as to provide 100 per cent cover to the first £35,000 of deposits.

D.13 The arrangements explicitly excluded other debt instruments such as covered bonds, securities issued by Granite⁶⁴ and subordinated and other hybrid capital instruments.

D.14 On 18 December, HM Treasury issued a press release noting that these wholesale guarantees were being extended.⁶⁵ The guarantees would now extend to existing and future unsubordinated wholesale obligations. In particular:

- all uncollateralised and unsubordinated wholesale deposits and other borrowings which are outside the guarantee arrangements previously announced by HM Treasury
- all payment obligations of Northern Rock plc under any uncollateralised derivative transactions
- in respect of all collateralised derivatives, and all wholesale borrowings which are collateralised (including, without limitation, covered bonds of Northern Rock plc), the payment obligations of Northern Rock plc to the extent that those obligations exceed the available proceeds of the realised collateral for the relevant derivative or borrowing, and
- all obligations of Northern Rock plc to make payments on the repurchase of mortgages under the documentation for the 'Granite' securitisation programme.

Further Bank of England facilities

D.15 The final category of public support was announced on 9 October 2007. HM Treasury, on behalf of the Tripartite Authorities, confirmed that the

⁶⁴ Granite is a special purpose vehicle established by Northern Rock to sell its mortgage backed securities to the market. It is now being run down.

⁶⁵ *Northern Rock plc: Extension of wholesale guarantee arrangements*, HMT press release, 18 December 2007, www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_149_07.cfm

Bank of England would provide additional facilities to Northern Rock to support its original September facility.

- D.16 These facilities were described as 'uncommitted', meaning they were not subject to any borrowing limit. Any money borrowed would be repayable on demand and subject to an interest premium paid to HM Treasury.
- D.17 Although the facilities are secured against Northern Rock's assets, in view of the scale and nature of the facilities, HM Treasury agreed to indemnify the Bank of England should it face a deficit. HM Treasury also indemnified the Bank of England against other liabilities that might arise from the Bank of England's role in the extended guarantee arrangements and additional facilities.
- D.18 In turn, Northern Rock has indemnified the Bank of England and HM Treasury in respect of the guarantee arrangements and certain costs and expenses, including HMT's advisor costs. The company has also agreed to the usual range of lender protections typical for facilities of this nature.