

## PROCEDURES RELATING TO THE IMPLEMENTATION OF THE COMPETITION POLICY

### COMMISSION

#### STATE AID — UNITED KINGDOM

#### State aid C 14/08 (ex NN 1/08) — Restructuring aid to Northern Rock

#### Invitation to submit comments pursuant to Article 88(2) of the EC Treaty

(Text with EEA relevance)

(2009/C 149/09)

By means of the letter dated 7 May 2009 reproduced in the authentic language on the pages following this summary, the Commission notified the United Kingdom of its decision to initiate the procedure laid down in Article 88(2) of the EC Treaty concerning the abovementioned measure.

Interested parties may submit their comments on the measure in respect of which the Commission is initiating the procedure within one month of the date of publication of this summary and the following letter, to:

European Commission  
Directorate-General for Competition  
State aid Greffe  
1049 Bruxelles/Brussel  
BELGIQUE/BELGIË  
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These comments will be communicated to the United Kingdom. Confidential treatment of the identity of the interested party submitting the comments may be requested in writing, stating the reasons for the request.

#### SUMMARY

##### I. PROCEDURE

1. On 2 April 2008 the Commission opened the procedure of Article 88(2) EC with regard to the restructuring plan submitted by the UK authorities for the restructuring of Northern Rock. The Commission received comments from the UK on 2 May 2008 and forwarded the comments of the other interested parties to it on 15 July 2008. The UK authorities responded to these comments on 28 August 2008. The Commission was subsequently provided with information by the UK authorities on various occasions. In the beginning of 2009, the UK authorities informed the Commission that they wished to amend the restructuring plan. They provided information regarding the new plan on 20 February 2009, 31 March 2009 and 2 April 2009.

##### II. FACTS

2. The beneficiary of the aid is NR, which was the 5th biggest UK mortgage bank with a balance-sheet total of GBP 101 billion (as per 31.12.2006). Residential mortgage lending is

NR's core activity. The bank roughly trebled its share on the UK mortgage market over the last 8 years. NR has financed the growth of its lending mainly via wholesale funding and by securitisation of its assets. This proved to be a problem when, because of the turbulence on the world's financial markets, the mortgage securitisation markets virtually closed, while raising funds on the wholesale money market became very difficult as banks were increasingly reluctant to lend to each other.

3. After guaranteeing the existing retail and wholesale deposits, new retail deposits and providing NR with a liquidity facility, the UK authorities nationalised NR in February 2008. On 17 March 2008, the UK authorities notified a restructuring plan to the Commission of which the most important elements were: (i) the reduction of the balance sheet by approximately [...] (\*) % from GBP 101 billion by end 2011, (ii) stabilisation of the balance sheet

(\*) Confidential information, where possible figures have been replaced by ranges in [brackets].

by increasing retail deposit base, (iii) closing business in Denmark and capping presence in Ireland and Guernsey. The plan would be supported by restructuring aid, which would mainly consist of prolongation of the rescue aid measures. The UK authorities were prepared to commit to a number of compensatory measures to limit the distortion of competition, including: (a) reduction of the balance sheet, (b) reduction in new mortgage origination, (c) closure of NR's business in Denmark and caps on business in Ireland and Guernsey and d) a Competitive Charter stating the basis on which NR would compete in the market.

4. As a result of the worsening financial crisis and the negative effect it had on NR's capital position, the UK authorities, together with NR, amended the restructuring plan. In the new plan, NR would be split into two entities:

(i) 'BankCo' to which assets the following assets from Northern Rock will be transferred: the retail deposit book (approximately GBP 19,5 bn), matched with approximately GBP [...] billion of cash assets and approximately GBP [...] billion of Northern Rock's [...] unencumbered mortgage assets. Wholesale deposits, currently totalling approximately GBP [...] billion, matched by cash assets, the Northern Rock mortgage origination and servicing platform, its branches, relevant staff and systems and the GIC accounts<sup>(1)</sup> matched by cash assets of an equal value (approximately GBP [...] billion);

(ii) 'AssetCo' will be the existing company, Northern Rock plc and will be left with the remaining pool of residential mortgages and Northern Rock's wholesale funding instruments (its interest in the Granite securitisation vehicle and its liabilities under the covered bond and EMTN programmes, together with associated hedging) together with the associated liabilities. AssetCo will also retain the liability for the existing Government loan to Northern Rock, which will be increased by between GBP [...] and GBP [...] billion (depending on the assets and liabilities at the time of the split) to enable the implementation of the restructuring and will be provided with a working capital facility of up to GBP [...] billion to ensure that it has adequate liquidity during the course of its [...]. A commercial rate will be charged for this facility.

5. The new restructuring plan also envisaged capital injections in BankCo and AssetCo of GBP [...] bln respectively GBP [...] bln in a base case scenario, a change in the lending strategy, abandonment of the active mortgage redemption programme and changes to the Competitive Framework which allow NR to increase its lending in 2009 and 2010 with GBP 14 billion in total.

<sup>(1)</sup> These are bank accounts in the name of the Granite securitisation structure that are held with NR.

### III. ASSESSMENT

6. As regards the restructuring aid notified on 31 March 2009, the Commission has decided to initiate a detailed investigation for the following reasons:

— First, the Commission observes that the new restructuring plan will free BankCo from having to obtain expensive funding on the market in order to absorb the losses on the risky loans made by NR in the past. This seems to amount to a form of impaired asset relief as the UK government essentially takes over much of the impaired assets from NR's activity as held by BankCo. BankCo also does not have to pay back the government loan and receives both the [...] assets of NR together with a considerable amount of cash. As a result BankCo seems to become a highly competitive bank. It is unclear whether the level of own contribution by BankCo satisfies the principles of the Rescue and Restructuring Guidelines. The Commission therefore doubts that the aid is limited to the minimum and that the own contribution by BankCo has been adequate.

— Secondly, the Commission doubts that the negative spill-over effects of the measures for the competitors have been limited to the minimum. As mentioned above BankCo seems, as a result of the restructuring operation, to emerge as a very competitive and well capitalised bank. As a result of the aid, BankCo can potentially increase its mortgage lending and consequently increase its presence on the market at the expense of other competitors, while unlike them, it does not have to shoulder the burden of the losses on its assets. The Commission also notes that BankCo will continue to manage the loans of AssetCo, which means it has the further advantage of keeping in contact with the existing clients. Taking into account the amount of aid, the Commission doubts whether the distortion of competition can be sufficiently offset by measures which aim to limit the distortion of competition.

### TEXT OF LETTER

The Commission wishes to inform the United Kingdom that, having examined the revised restructuring plan such as notified by your authorities regarding the case referred to above, it has decided to extend the procedure laid down in Article 88(2) of the EC Treaty which was opened by decision C(2008)1210 final of 2 April 2008 ("the opening decision").

### 1. PROCEDURE

(1) On 17 March 2008, the UK authorities submitted to the Commission a restructuring plan for Northern Rock ("NR") and notified the State aid measures which would accompany that plan to enable it to be implemented. On 2 April 2008, the Commission opened a formal investigation procedure pursuant to Article 88(2) EC Treaty regarding the restructuring aid planned to be granted to Northern Rock. By letter of 2 May 2008, the UK responded to the opening decision.

- (2) By letter of 25 April 2008, the Commission sent questions regarding the restructuring plan submitted on 31 March 2008, which was a slightly amended version of the plan notified on 17 March 2008. The UK provided answers by letter of 6 June 2008. On 30 June 2008, a meeting was held between the Commission services and the UK authorities. Following that meeting, the UK authorities provided additional information by letter of 13 August 2008. The UK authorities also provided information by letter of 8 July 2008.
- (3) The opening decision was published in the *Official Journal of the European Union* <sup>(1)</sup>. The Commission invited interested parties to submit their comments on the aid. The Commission has received comments from interested parties. By letter of 15 July 2008, received on 31 July 2008, it has forwarded them to the UK, which was given the opportunity to react; its comments were received by letter of 29 August 2008.
- (4) On 5 August 2008, the UK government announced that it intended to convert up to 3 billion pounds of loans to Northern Rock into equity.
- (5) On 11 November 2008, 15 January 2009 and 4 February 2009, the UK authorities informed the Commission that it was considering plans for restructuring NR which significantly differed from the ones notified in March 2008 and outlined these plans.
- (6) On 20 February 2009, the UK authorities provided additional information on the intention to split the NR in two. A more detailed plan was notified by letter of 31 March 2009 and 2 April 2009.

## 2. DESCRIPTION

### 2.1. The beneficiary and its difficulties

- (7) Before the difficulties started in the second half of 2007, NR was the 5th biggest UK mortgage bank with a balance-sheet total of GBP 113,5 billion on 30 June 2007. In 2006, its interest income represented GBP 5 billion, with a profit of GBP 443 million. The bank had a staff of 6 000 persons. NR has 77 branches throughout the UK and was present in Ireland, Denmark and Guernsey. Residential mortgage lending was NR's core activity. It represented more than 90 % of all outstanding loans to customers. 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 % <sup>(2)</sup>. NR financed the majority of its long-term mortgage loans by issuing securitised notes. In March 2001 NR established a "master trust" securitisation structure known as "Granite" of which it has made extensive use. NR also funded itself through the issue of "covered bonds".
- (8) In section 2.1 of the first opening decision, the Commission provided more information on the beneficiary. Section 2.2 of the opening decision described the difficulties it encountered, which led the UK authorities to provide loans and guarantees, which were approved as

rescue aid by the Commission Decision of 5 December 2007 <sup>(3)</sup>. Some of the loans were initially granted by the Bank of England ("BoE") and counter-guaranteed by the State. All the loans granted by BoE were novated on 28 August 2008 to HM Treasury. Section 2.3.1 of the opening decision described the circumstances which led the State to provide additional state guarantees on 18 December 2007. (In section 4.5.2 of the opening decision, the Commission concluded that these additional guarantees constituted compatible rescue aid.) Sections 2.3.2 and 2.3.3 of the opening decision described respectively the attempts by NR and the UK authorities to find a private sector solution and the restructuring plans submitted to the government by Virgin and by NR's management. Section 2.3.4 indicated that NR was nationalised on 22 February 2008 on the basis of legislation introduced the preceding days.

### 2.2. The restructuring plan notified on 17 March 2008

- (9) The restructuring plan notified on 17 March 2008 was described in section 2.3.5 of the first opening decision. The main elements of this plan are summarised once more here below, in order to facilitate the comparison with the new restructuring plan.
- (10) As regards the size of the balance sheet, the plan notified on 17 March 2008 envisaged that the NR balance sheet would contract in the first five years of the plan from about GBP 107 billion in 2007 to about GBP 48-53 billion at the end of 2011. This would be achieved through an active retail mortgage redemption programme with the aim of encouraging at least 60 % of customers with maturing products (i.e. maturing from product deals) to remortgage with another lender; and exiting all new commercial lending and new standalone unsecured lending. NR would also continue to conduct limited levels of new lending over this period (in the base case about 18-23 billion in total for the four years from 2008 to 2011 compared with more than GBP 30 billion in 2007). This new lending would be offered predominantly to high credit quality new customers.
- (11) As to the structure of funding and limiting maturity mismatch, the plan envisaged that the proportion of retail funding to total funding would increase from 15-20 % in 2008 to about [...] <sup>(4)</sup> in 2011 and about [...] in 2012, re-balancing the balance sheet. This would be reflected in a decrease in total funding and an increase in retail deposits from GBP 10,5 billion at the end of 2007 (i.e. after the bank run) to about GBP [...] billion in 2011, which remains below the pre-crisis level of GBP 24 billion. The projected growth in the deposit base represented a moderate increase in the share of the total market compared to levels prevailing at the time (about 1,2-1,5 % compared to 0,8 %) and below the pre-crisis share of 1,9 % for the duration of the restructuring period.
- (12) As regards overseas activities, NR proposed that its Danish operations would be closed and a small capability would be retained in Ireland and Guernsey to maintain some diversification of the funding base.

<sup>(1)</sup> OJ C 135, 3.6.2008, p. 21.

<sup>(2)</sup> Gross lending is total advances, and net lending is advances less redemptions and repayments.

<sup>(3)</sup> OJ C 43, 16.2.2008.

<sup>(4)</sup> Business secret, where possible, figures have been replaced by ranges in [brackets].

- (13) As regards the BoE facilities, the plan's priority was their rapid repayment. The plan envisaged that these facilities would be fully repaid around [...] 2010 in the base case, although there would be a BoE/Treasury liquidity facility that might remain in place until about the end of [...].
- (14) As regards the State guarantees, the plan envisaged, in the base case, the removal of all guarantees by the end of 2011. There would be a staggered release. As regards the retail funding guarantee arrangements (which cover all new and existing retail deposits) in the base case, the indicative earliest release date for new retail deposits would be [...]. The indicative earliest release date for existing retail deposits would be the [...]. For non-retail deposits, the indicative date for removal of the guarantees in the base case would be during [...]. Under the recession case scenario, the guarantee arrangements would be required until about 2013. The precise timing of the release of the guarantee arrangements would be driven by capital requirements and market conditions.
- (15) As regards management, there was a significant change in the composition of the board with the appointment of a new executive Chairman, a new Chief Financial Officer, and three new non-executive directors appointed by the Government.
- (16) As regards compensatory measure, the Government was prepared to commit to the following specific measures:
- (i) A targeted reduction in the balance sheet by over [...] % to about GBP 48-53 billion by 2011.
  - (ii) A reduction of new residential mortgage origination from (in the base case) over GBP 30 billion in 2007 to about GBP 18-23 billion in total for the four years from 2008 to 2011, and in any event within the limits of the market share cap on gross new lending.
  - (iii) A commitment to an aggressive redemption policy including the active encouragement of redeeming customers to move to competitors.
  - (iv) Closure and run-off of NR's operations in Denmark in 2008 and a commitment not to expand in other EU markets before 2011.
  - (v) A commitment to a "Competitive Charter", which would notably include commitments that:
    - (i) NR would not promote its Government backing in any market;
    - (ii) NR would not allow its share of retail deposit balances to exceed 1,5 % in the UK and [0,8-1 %] in Ireland;
    - (iii) NR would limit its share of gross new mortgage origination to below 2,5 % in any calendar year;
    - (iv) NR would ensure that it would not rank within the top positions in the defined 15 Moneyfacts retail deposit categories for the remainder of 2008;
- (vi) A commitment to withdraw from unsecured personal lending and commercial lending for the restructuring period.
- (vii) A commitment not to increase the overall number of branches in the UK.
- (17) The plan envisaged that these compensatory measures, unless otherwise specified above, would remain in place until such time as the BoE/Treasury financial assistance has been fully repaid (and the liquidity facility transferred to a third party provider) and the balance sheet guarantee arrangements have been released in full.
- 2.3. The new restructuring plan notified on 2 April 2009**
- (18) From December 2007 onwards, Northern Rock's capital position has deteriorated significantly. By December 2008 Core Tier 1 capital had fallen to -GBP 17,1 million and total Tier 1 capital (after deductions) to -GBP 110,4 million due to severe losses incurred by Northern Rock as a result of the global financial crisis. <sup>(1)</sup> In addition the reduction in the company's balance sheet in accordance with the original restructuring plan, combined with the effects of the financial crisis has led to an increase in the risk weighting of assets in the short to medium term as the credit quality of the remaining book decreased, leading to an effective increase in Tier 1 capital requirements. Revised projections now indicate that up to GBP [...] billion of additional capital would be required under the plan of March 2008 if the deterioration of the book continues.
- (19) Given the significant interest rate cuts as a result of the financial crisis and the consequential reduction of Northern Rock's SVR <sup>(2)</sup>, the company also anticipates a significant reduction in the rate of mortgage redemptions in 2009. In the restructuring plan that was notified in March 2008, it was expected that 60 % of customers maturing from product deals would redeem in 2009. This is now expected to reduce to around [30 %-40 %].
- (20) In light of these concerns, the Government and Northern Rock have agreed a number of modifications to the restructuring plan as originally set out in March 2008 in order to recognise the significant change in market conditions over this period, address the capital position, and support the wider initiatives that the Government is taking to support the UK economy.
- 2.3.1. The split of the bank in a bad bank and a good bank**
- (21) The core proposal is that there will be a restructuring of the business so that the majority of the back book of mortgages, and Northern Rock's existing wholesale funding arrangements, will be managed separately from its other businesses. Northern Rock will be divided into:

<sup>(1)</sup> NR has registered a pre-tax loss of approximately GBP 1,4 billion over 2008 and the reserves decreased significantly if compared to the end of 2007 as stated in its 2008 annual accounts [http://companyinfo.northernrock.co.uk/downloads/2008\\_annual\\_report.pdf](http://companyinfo.northernrock.co.uk/downloads/2008_annual_report.pdf)

<sup>(2)</sup> UK term for each lender's standard variable mortgage lending rate.

- (i) "BankCo" which will be a new company authorised by the FSA as a deposit taker. Assets will be transferred from Northern Rock to BankCo by order under the Banking (Special Provisions) Act 2008. These are expected to include the retail deposit book, currently standing at approximately GBP 19,5 bn, matched with approximately GBP [...] billion of cash assets and approximately GBP [...] billion of Northern Rock's [...] unencumbered mortgage assets. Wholesale deposits, currently totalling approximately GBP [...] billion, will also be transferred to BankCo, matched by cash assets of an equal value.<sup>(1)</sup> BankCo will also contain the Northern Rock mortgage origination and servicing platform, its branches (including the branch in Ireland and the Guernsey subsidiary), relevant staff and systems. In addition, the intention is that the GIC accounts<sup>(2)</sup> will be transferred to BankCo, matched by cash assets of an equal value (approximately GBP [...] billion); this is likely to be dependent on the company's rating and the decision of Granite's trustees.
- (ii) "AssetCo" which will be the existing company, Northern Rock plc. The intention is that AssetCo will be left with the remaining pool of residential mortgages and Northern Rock's wholesale funding instruments (principally its interest in the Granite securitisation vehicle and its liabilities under the covered bond and EMTN programmes, together with associated hedging) together with the associated liabilities. AssetCo will also retain the liability for the existing Government loan to Northern Rock, which will be increased by between GBP [...] and GBP [...] billion (exact amount to be set depending on the assets and liabilities that exist at the time of the split) to enable the implementation of the restructuring. In addition, the Government will provide AssetCo with a working capital facility of up to GBP [...] billion to ensure that it has adequate liquidity during the course of its [...]. A commercial rate will be charged for this facility.
- (22) There will be a service agreement between the two companies under which BankCo is likely to manage AssetCo's mortgage book and its other remaining assets and liabilities. It is envisaged that any regulated activities that AssetCo would otherwise need to perform will be carried out by BankCo under the service agreement. FSA approval of these arrangements will be required in order to enable the two entities to be capitalised separately.
- (23) The current assumption is that AssetCo will be wound down [...]. To the extent that AssetCo's assets are not sufficient to fund repayment of its liabilities [...], further Government support may be required to permit a [...].
- (24) In the immediate future both BankCo and AssetCo will remain wholly owned by the Government. However, it is intended that the implementation of this structure will also assist in facilitating a return of BankCo to the private sector, and to independent operation, at an earlier date than would otherwise be the case.
- (25) In order to address the negative evolution of Northern Rock's regulatory capital base the Government had previously agreed in August 2008 to convert GBP 400 million of preference shares, and up to GBP 3 billion of the loan from the Government into ordinary shares of the company. In light of the proposed restructuring these proposals will not be implemented in this form, but as follows:
- BankCo will need to be capitalised by the Government with equity and, potentially, subordinated or other forms of long term debt in order to meet its regulatory capital requirements in a central and stress case scenario. In a stress case scenario its total capital requirement is expected to be up to GBP [...] billion.
  - AssetCo is currently expected to be subject to a regulatory capital requirement of 1 % in the medium term, reflecting its activities as a [...]. In the medium to long term, the intention is that AssetCo will reduce its activities such that it falls outside the scope of the FSA. However, in the short term, it will need to satisfy FSA requirements before its capital requirements are reduced. In a central case AssetCo is not expected to require any capital support from the Government. However, in a stress scenario (and based on a 1 % regulatory capital requirement) AssetCo could require support of around GBP [...] billion to cover a capital shortfall in 2010-11, although capital is forecast to recover to a positive position in [...]. The current intention of the Government is to ensure AssetCo is able to fund repayment of its liabilities as they fall due and its ongoing operations should its assets not be sufficient.
- (26) The capital requirements in a stress scenario under the revised structure therefore total approximately GBP [...] billion (in line with the August 2008 proposals). The reason for the lower capital requirements is that under the revised structure the bulk of the assets that are the most capital-absorptive are held in run-off in an entity which, in the medium to long term, and subject to AssetCo falling outside the scope of the FSA's remit, is expected to have no regulatory capital requirement.
- (27) Northern Rock's capital position has been addressed to date through a continuation of the interim arrangements that were set up at the same time as the August 2008 proposals. At the company's request, the FSA agreed to waive the limits on use of Tier 2 capital that would otherwise have applied as a result of the reduction in the level of total Tier 1 resources. This means that all available Tier 2 capital can be included within the capital resources of the company for the purposes of meeting the Company's minimum regulatory requirements. These arrangements were implemented on a temporary basis until the earlier of the recapitalisation of the Company or 31 December 2008. The arrangements were subsequently renewed [...].
- <sup>(1)</sup> The total cash transfer that is necessary to ensure that the value of the liabilities transferred to BankCo does not outweigh the value of the assets transferred will be funded principally through the extension of the current loan to Northern Rock (liability for which will rest with AssetCo).
- <sup>(2)</sup> These are bank accounts in the name of the Granite securitisation structure that are held with NR.

### 2.3.3. Amendments to Government loan

- (28) In addition to the increase, described above, in the existing loan to Northern Rock, there will also be an adjustment to the terms of the loan. This will extend final repayment of the loan to beyond [...] (or to the liquidation of AssetCo if earlier). The rate of interest will also be reviewed and a new future rate will be agreed between the Government and the company. Northern Rock plc currently pays interest at Bank of England base rate plus [...] bps. As set out in the loan agreement, this will revert to [...] plus [...] bps when state aid approval is granted, backdated to [...]. The future rate of interest to be charged on the loan is not yet fixed but will be at least [...].

### 2.3.4. Amendments to lending strategy

- (29) On 19 January 2009 the Government announced a series of measures designed to reinforce the stability of the financial system, increase capacity and confidence to lend, and in turn to support the recovery of the UK economy. This included an announcement that Northern Rock would no longer actively pursue a policy of rapidly reducing its mortgage book. On 23 February 2009 a further press release confirmed that Northern Rock would be increasing mortgage lending by up to GBP 14 billion over the next two years (GBP 5 billion in 2009 and up to GBP 9 billion in 2010) on a range of products. Existing customers will also no longer be actively encouraged to leave Northern Rock when their mortgage arrangements become freely renewable. The new lending will be subject to market demand and will take place on commercial terms. The new lending will be funded from the opening cash transferred to the BankCo business, deposits with BankCo, and repayments on its loan book.

### 2.3.5. [...] guarantee arrangements

- (30) The March 2008 business plan envisaged the release of all guarantees by the end of 2011 (in the base case). This date was conditional on a number of factors, including repayment of the Government loan and a robust capital position ([...]). [...].
- (31) [...]. All guarantee arrangements are subject to a minimum period of three months between the Government giving notice and guarantees being lifted. However, some products (such as fixed term bonds) are guaranteed for their term, so in these instances guarantees will roll off as the products expire.
- (32) [...]. It is likely that BankCo will need to achieve an A-long term rating from credit rating agencies in order to be able to access the wholesale markets. [...]. The wholesale guarantee arrangements for AssetCo are likely to remain in place until exit or liquidation.

### 2.3.6. Revised Competitive Framework

- (33) NR has operated within the terms of the Competitive Framework to date. It is proposed that the Competitive Framework will continue to restrict the activities of BankCo for 12 months [...], although there will be some adjustments required to accommodate the revised lending strategy. More specifically:

— BankCo will limit its new mortgage lending to GBP 5 billion in the UK in 2009 and GBP 4,5 billion in the first half of 2010.

- It will also restrict the level of total retail deposit balances to no more than GBP 21 billion at any stage prior to 30 June 2010 (current retail balances amount to GBP 19,5 billion). The effect of this will be an earlier increase in the level of retail deposits than forecasted in the original plan. The March 2008 plan envisaged retail deposits of GBP 15 billion in 2009 growing to approximately GBP 26 billion in 2013. These will now be approximately GBP [...] billion in 2009 [...] growing to an indicative figure of GBP 25 billion by 2013.
- BankCo would also continue to follow the previous commitments to not promoting its Government backing.

- (34) Modified commitments in the Competitive Charter have been framed in terms of absolute numbers, rather than market shares as this is more predictable and easier to assess given the volatility in the size and composition of the market.

## 3. POSITION OF THE UK

- (35) The UK Government recalls that since the notification of the restructuring plan in March 2008, the situation of the world financial market and the UK economy has dramatically worsened. Several financial institutions which were present in the UK have withdrawn from the country and some of the largest UK banks are facing extreme difficulties which causes them to reduce their lending (and risk weighted assets) in order to reduce their capital requirements and improve their solvency ratios. As a consequence, the supply of mortgage loans has been severely reduced, especially for loans with high loan-to-value ratios (LTV). House prices in the UK have already declined by around 20 % compared to their highest level. Each additional decline is creating additional losses for banks, which further depletes their capital, and is increasing the risk weighting of their existing loans. Consequently, the banks further reduce new lending, which in turn contributes to reduce the demand for houses and increases downwards pressure on house prices, thus creating a downwards spiral.
- (36) In response to this crisis, the Government has introduced new measures <sup>(1)</sup> and granted aid to several banks.
- (37) The UK authorities recall that Northern Rock has made significant progress in repaying the Government loan to date, primarily as a result of its mortgage redemption programme under which it provides assistance to customers to access new products with alternative lenders. From a peak of approximately GBP 27 billion at the end of December 2007, Northern Rock had repaid GBP 12,5 billion on a gross basis by the end of March 2009 and remains ahead of schedule on its loan repayments. The company has also been successful in implementing other elements of the plan, including a significant reduction in its balance sheet from GBP 107 billion as at December 2007 to GBP 93 billion as at 31 December 2008 (excluding the fair value of derivatives)

<sup>(1)</sup> Aid to Bradford & Bingley in late September 2008, introduction of a recapitalisation scheme and a of a credit guarantee scheme in October 2008, announcement of an asset protection scheme on 19 July 2009.

and an increase in its level of retail funding from 10 % (at year end 2007) to 20 % (at year end 2008), withdrawal from the Danish market and from its unsecured lending business, and full compliance with the market share caps and pricing restrictions set out in its Competitive Framework. This has required Northern Rock to forego significant commercial opportunities, including giving up a large number of high credit quality profitable customers through its active mortgage redemption programme.

(38) The Government takes the view that the amendments that are proposed to the Northern Rock plan do not materially change the analysis of these arrangements under the rescue and restructuring guidelines. In particular:

— The increase in mortgage lending is consistent with the strong progress that the company has made to redeem its existing mortgage book and repay Government lending. It should also be regarded as a measure in support of wider Government intervention to address concerns about the impact of the financial crisis on the wider economy.

— Although retail deposits will increase sooner than previously envisaged, they will remain within the limits set out in the revised Competitive Framework and by 2013 the level of deposits is forecast to be less than the March 2008 business plan.

— The restructuring proposals will assist in minimising the overall level of aid to Northern Rock by reducing the overall regulatory capital requirement of the two businesses.

— [...].

— The company has made a significant contribution to the costs of the restructuring in the form of the sale of the Herm portfolio and the accelerated monetisation of assets to date as described in the March 2008 plan as well as the closure of Northern Rock's branch in Denmark in June 2008.

— The Competitive Framework will continue to restrict the activities of BankCo for 12 months [...], although there will be some adjustments required to accommodate the revised lending strategy. Distortions of competition as a result of the aid will therefore continue to be minimised, and in reality the competitive impact of the arrangements in relation to Northern Rock are in any event likely to be eclipsed by the wider dislocations in the market for some time.

#### 4. ASSESSMENT

##### 4.1. Existence of aid

(39) The Commission must assess whether the measures introduced or modified by the new restructuring plan constitute State aid. Article 87(1) EC lays down that any aid granted by a Member State or through State resources in any form whatsoever 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.

(40) The UK Government intends to introduce new measures and to amend existing ones in favour of AssetCo and BankCo. As such, all measures described below (increased amount of government loans, working capital facility, guarantees and capital injections in favour of AssetCo and asset relief measure in favour of BankCo, see paragraph (45)) are financed through State resources. Before individually describing these measures in more detail and assessing whether they confer a selective advantage on AssetCo and BankCo, the Commission will first assess whether State support is able to distort competition and affect trade between the Member States.

(41) Under the new plan, AssetCo will presumably not carry out any economic activities on markets where it will be in competition with other banks. It will not collect any new deposits and will not make any new loans. Instead, it will, according to the UK authorities, only realise its assets as they mature and use the proceeds of these to repay its debts as they become due and fund its ongoing operational requirements as well as any retained historic liabilities.

(42) The Commission considers that this fact does however not entail that the State measures in favour of AssetCo do not distort competition. Indeed, all the notified State measures in favour of AssetCo allow a [...] of the latter, meaning that the creditors of AssetCo will be repaid [...]. If the State were not to ensure the [...] of AssetCo, the creditors of AssetCo would not allow the transfer of the [...] assets and [...] liabilities to BankCo as it would reduce their chances of obtaining repayment of their claims by AssetCo. The notified State aids which are in favour of AssetCo are therefore necessary to facilitate the transfer to BankCo of AssetCo/NR's retail deposits, mortgage writing platform and some of its good quality mortgages in order for it to continue to operate on the market<sup>(1)</sup>.

(43) The Commission therefore considers that the State measures ensuring a [...] of AssetCo are also directly benefiting BankCo, as it will be able to continue its activities relatively unburdened by possible impairments on the lower quality assets, since they would have been transferred to AssetCo. As a result, BankCo has an advantage over its competitors that are faced with impairments on lower quality assets, which they have to absorb, limiting the funds available for new lending. This leads to a distortion of competition.

<sup>(1)</sup> This is consistent with the Commission's analysis in the Bradford and Bingley decision, NN41/2008, *Bradford and Bingley*, OJ C 290 13.11.2008, p. 1.

(44) It observes that BankCo will be a bank competing among others on the UK retail deposit market and on the UK mortgage lending market. In these two markets, some competitors are subsidiaries of foreign banks. The Commission concludes that since the State measures favouring AssetCo also directly favour BankCo, they distort competition and affect trade between Member States.

(45) The State measures which confer a selective advantage on AssetCo are the following ones:

(i) The State plans to inject up to GBP [...] billion in AssetCo (in a stress case scenario). The Commission considers that the private investor test is not applicable to this capital injection since this transaction follows several aid measures in favour of NR/AssetCo and is implemented in parallel with several additional aid measures<sup>(1)</sup>. In addition, if it were applicable, this test would not be fulfilled since AssetCo's assets will be made of NR's [...] mortgage loans, unsecured personal loans and commercial loans, which are all likely to show a significant rate of default in this period of severe recession. It is therefore unlikely to be profitable for a private investor to provide capital to AssetCo. This measure favours AssetCo by allowing it to have sufficient capital to meet the FSA requirement. This allows a [...] of AssetCo and therefore favours also BankCo, as explained above. On that basis, the Commission concludes that this measure constitutes aid and invites the UK authorities to provide more information on the size of the capital injection and its terms.

(ii) The State guarantees covering the wholesale liabilities of AssetCo are likely to remain in place until State exit or liquidation. The Commission already concluded that these arrangements are State aid in the opening decision. The UK authorities are invited to provide details on the total exposures covered by these guarantee arrangements and their anticipated amortisation over time under the new plan. These State guarantees allow a [...] of AssetCo and therefore favour BankCo. On that basis, the Commission concludes that these measures constitute aid.

(iii) Government will provide AssetCo with a working capital facility of up to GBP [...] billion to ensure that it has adequate liquidity during the course of its [...]. The Commission invites the UK authorities to provide it with more information on this facility. More generally, the UK authorities intend to ensure a [...] of AssetCo and therefore intend to commit to provide any additional support necessary to AssetCo to allow it to [...]. This working capital facility and this State commitment of providing further aid if necessary allows a [...] of AssetCo. As explained

above, this favours BankCo. On that basis, the Commission concludes that these State measures constitute aid.

(iv) The State will increase the overall level and duration of its lending to NR/AssetCo. It will increase by between GBP [...] and GBP [...] billion and ultimate repayment will be deferred to beyond [...]. The delayed reimbursement allows a [...] of AssetCo. The increased lending allows AssetCo to transfer billions of cash to BankCo. It is therefore clear that the new tenor and amount of the State lending favour also BankCo. On that basis, the Commission concludes that these State measures constitute aid and requests the UK authorities to submit more information on these measures.

(46) As indicated above, all the State measures ensuring a [...] of AssetCo allow the separation of AssetCo/NR branches, its mortgage writing platform, some of its [...] mortgage loans and the retail deposits into BankCo. Taking into account all the above considerations, the Commission considers that the effect of the measures in favour of AssetCo is equivalent, from an economic point of view, to a purchase of the assets of Northern Rock by the State for the following reasons. Firstly, a private operator would not have been able to structure such an operation. Indeed, it seems that the State had to make use of its prerogative powers to structure this operation. Indeed, any private operators placed in a similar situation as NR would not have been able to separate the good assets from the bad and to maintain NR economic activity without a significant capital increase. Secondly, the operation of the State [...] of AssetCo's liabilities can be considered from an economic point of view to be equivalent to a purchase of non-performing assets of NR, which would allow BankCo to continue to pursue NR's economic activities. Indeed, the Commission considers that, although BankCo is newly created, it continues NR's economic activities since it provides services to the whole existing back book of NR before the operation. In particular, the customer relationship and the management of performing assets are all confined to BankCo. As confirmed by the reduced capital required by the FSA, the Commission considers that AssetCo could be seen as a State-owned vehicle whose aim is to reduce the capital requirements for BankCo pursuing NR's economic activities. Finally, the Commission considers that the State aid in the present case is not aimed at liquidating a financial institution in difficulty and limiting the State exposure by auctioning the economic activity and/or financial institution's assets on the market, but at reducing the capital injection that the State would have had to carry out otherwise as the unique shareholder of NR.

#### *Aid at the level of BankCo*

(47) Taking into account the above considerations, BankCo is a "good bank" which will operate the healthy assets of NR and will be freed from all the bad assets of NR. Under the Communication from the Commission on the *Treatment of Impaired Assets in the Community Banking Sector*<sup>(2)</sup> ('the Impaired Assets Communication'), the aid element in such a transaction is the difference between the market

<sup>(1)</sup> Since AssetCo is the existing company Northern Rock plc, the Commission can at this stage not exclude that the injection of capital into AssetCo is the implementation of the commitment made by HM Treasury that it will ensure that NR will operate above the minimum capital requirements (this commitment was discussed in paragraph 91 of the opening decision). The Commission invites the UK authorities to provide their comments on that issue. If this capital injection is the implementation of the prior commitment, this would entail that the aid was granted already at that date but this would not affect the qualification of the measure as constituting aid or not.

<sup>(2)</sup> OJ C 72, 26.3.2009, p. 1.

value of the assets guaranteed or purchased by the State and the price at which these assets have been guaranteed or purchased. In the present case, the aid element to BankCo is therefore the difference between the market value of the assets remaining in AssetCo and their value in the books of AssetCo<sup>(1)</sup>. The Commission therefore invites the UK authorities to provide this information.

- (48) In addition to the foregoing measures granted to AssetCo, the Government also intends to inject up to GBP [...] billion (in a stress case scenario) of capital in BankCo. It is not excluded that BankCo will be a profitable company, since it will have a portfolio of good quality mortgages and a lot of cash to make new lending. It is therefore possible that this investment will be profitable and that even a private investor could have done such investment. However, the Commission considers that the private investor test is not applicable to this capital injection since this transaction follows several aid measures in favour of NR<sup>(2)</sup> and is implemented in parallel with several additional aid measures. The measure can therefore not be assessed separately from the rest of the state interventions in favour of NR/AssetCo, which allows the transfer to BankCo of the good assets and liabilities of NR and a significant amount of cash. The selective measures in favour of BankCo therefore constitute aid.
- (49) Finally, in order for the Commission to properly assess the aid measures, the UK authorities are invited to present, in addition to the information on the notified measures, a full list of the measures already granted or planned to be granted to Northern Rock under any existing aid scheme.

## 4.2. Compatibility of the aid

### 4.2.1. The legal basis for the compatibility assessment of the aid

- (50) In its first opening decision of 2 April 2008, the Commission's position was that the measure could at that stage not be found compatible with the common market pursuant to Article 87(3)(b) EC, because the aid did not seem to tackle a disturbance in an entire Member State, but instead aimed to address individual problems specific to the situation of NR.<sup>(3)</sup> In particular, the Commission observed in the opening decision that, although a bankruptcy of NR would have had negative spill-over effects for other banks, the information provided by the UK had not convinced it at that point in time that these negative consequences could have reached a size constituting a serious disturbance in the economy of the UK within the meaning of Article 87(3)(b) EC.

<sup>(1)</sup> Indeed, AssetCo will be financed, capitalised and guaranteed by the State. In other words, any loss incurred on the assets of AssetCo compared to the current book value will be supported by the State. The Commission therefore considers the transfer value in the meaning of the Impaired Asset Communication to be the current book value of the assets of AssetCo.

<sup>(2)</sup> It is recalled that BankCo will be created on the basis of the retail deposit balances and the mortgage lending platform of NR.

<sup>(3)</sup> Paragraphs 100 and 101 of the first opening decision.

- (51) In the meantime, the Commission has acknowledged in its three Communications<sup>(4)</sup> and in its various approvals of the measures undertaken by the UK to combat the financial crisis<sup>(5)</sup>, that there is serious disturbance in the UK economy and that measures supporting banks are apt to remedy serious disturbance in the UK economy. Therefore the legal basis for the assessment of the aid measures shall be Article 87(3)(b) EC.

- (52) As the Commission has set out in the three Communications adopted in the context of the current financial crisis<sup>(6)</sup>, aid measures granted to banks in the context of the ongoing financial crisis should be assessed in line with the principles of the rescue and restructuring aid Guidelines, while taking into consideration the particular features of the systemic crisis in the financial markets<sup>(7)</sup>. That means that the principles of the rescue and restructuring aid Guidelines may have to be adapted when applied to the restructuring of Northern Rock in the present crisis, which is assessed on the basis of Article 87(3)(b) EC. Within this context attention should be given to the rules set out in the rescue and restructuring aid Guidelines for own contribution. Given the fact that the external financing for Northern Rock has dried up and that the 50 % requirement set in rescue and restructuring aid Guidelines appears unfeasible in the current economic setting, the Commission accepts that during the crisis in the financial markets it may not be appropriate to request that the own contribution represents a predefined proportion of the costs of restructuring. Furthermore the design and implementation of measures to limit distortion of competition may also need to be reconsidered in so far as Northern Rock may need more time for their implementation due to the current market circumstances.

- (53) As the Commission has indicated in previous guidance, the depth of restructuring required to return to viability should at least be in direct proportion on the one hand to the scope and volume of the aid provided to NR and on the other to the fragility of its business model.

### 4.2.2. Compatibility assessment under Article 87(3)(b) EC

- (54) In view of the above it follows that in order to assess the compatibility of the aid to NR on the basis of Article 87(3)(b) EC, the Commission has to assess (i)

<sup>(4)</sup> Banking Communication, OJ C 270, 25.10.2008 p. 8, Recapitalisation Communication, OJ C 10, 15.1.2009 p. 2, and Impaired Assets Communication (see footnote 7 above).

<sup>(5)</sup> See amongst others Commission Decisions regarding: Financial support measures to banking sector in the UK (N 507/2008), OJ C 290 13.11.2008 p. 1 and the Working Capital Guarantee Scheme (N 111/2008) to be published in OJ.

<sup>(6)</sup> Communication from the Commission — Application of the State Aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 25.10.2008, p. 8. points 10, 32, 42; Communication from the Commission — Recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, OJ C 10, 15.1.2009, p. 2, point 44. Communication from the Commission on the Treatment of Impaired Assets in the Community banking sector, OJ C 72, 26.3.2009, p. 1, point 17 and 58 et seq.

<sup>(7)</sup> See explicitly the Banking Communication — Application of the State Aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 25.10.2008, p. 8. point 42.

whether the restructuring plan is able to restore the long-term viability, (ii) whether the aid is limited to the minimum and (iii) whether the negative spill-over effects of the aid is limited.

(55) More generally, and in line with paragraph (47) above, the Commission invites the UK authorities to present all the necessary information justifying that the measure is consistent with the guidance set out in the Impaired Assets Communication. In particular, the UK authorities are invited to present more information on the national legal basis of the measure, whether the assets retained in AssetCo fulfilled the eligibility conditions and whether the valuation and pricing of the measure is consistent with these requirements.

(i) Restoration of long-term viability

(56) With regard to the restoration of long term viability, the new restructuring plan seems to ensure the long term viability of BankCo. Indeed under the plan BankCo will not inherit the problems of NR. [...] loans of NR will remain with AssetCo. In addition, BankCo will initially have a very liquid balance sheet thanks to large amounts of cash received from AssetCo. Moreover, the about [...] % of the funding will come from retail deposits, thereby diversifying the sources of liquidity.

(57) It would seem therefore that BankCo, as a result of these measures, does not risk encountering the same liquidity problems as faced by NR due to its high dependence on wholesale funding combined with long term assets. Nevertheless, the Commission observes that the UK authorities have not provided a detailed business plan that explains how BankCo will become a viable entity on a sustainable basis over the medium to long term. At this stage, viability of BankCo therefore has not been demonstrated. The Commission therefore invites the UK authorities and third parties to comment on this issue.

(ii) Aid limited to the minimum/own contribution

(58) As regards the limitation of the aid to the minimum, the Commission observes that the aid is of such a type and quantity that it would allow BankCo to be freed of having to obtain expensive funding on the current market in order to absorb the losses on a large majority of high risk loans made by NR in the past. Therefore, it would not have to support the losses on these loans. Also, BankCo would be freed from having to pay back the government loans, as they would be transferred to AssetCo. BankCo would [...] receive the [...] assets of NR and will initially have a lot of cash. In other words, the aid seems to allow the creation of a very competitive new bank, instead of only restoring the long term viability of the existing bank. The Commission therefore strongly doubts that the aid is limited to the minimum. It seems that recapitalising NR would have requested less aid and of a much shorter duration.

(59) As regards the limitation of the aid to the minimum, the Commission also notes that according to the Impaired Assets Communication, the State should guarantee or purchase impaired assets at a value not exceeding their real economic value. In the present case, the State accepts to fully finance and support the losses of the assets of AssetCo, whereas their book value seems signifi-

cantly higher than their real economic value, since this book value does not take into account future losses on these risky loans which will be caused by the current recession. This seems to be an additional indication that the aid is above the minimum necessary and that there is no adequate burden sharing as requested in paragraph 5.2 of the Impaired Assets Communication.

(60) Furthermore, the Commission's doubts as regards the own contribution of NR to the restructuring have not been allayed by the UK authorities. The Commission observes that the restriction on new lending and the active redemption policy, which had allowed the accelerated redemption of the State loan in the last quarter, as planned in the original restructuring plan, has been abandoned and even reversed. Indeed, the AssetCo will draw additional resources under the loan facility. The Commission therefore doubts that the own contribution is sufficient and invites the UK authorities and third parties to comment on this issue.

(iii) Limiting negative spill-over effects and undue distortion competition/measures which limit the distortion of competition

(61) The funding provided to BankCo for the mortgage lending through the split-up of NR into BankCo and AssetCo could have negative spill-over effects on competitors. As a result of the funding, BankCo could increase its mortgage lending and consequently potentially increase its presence on that market at the expense of other competitors. The limits imposed by the Competitive Framework, as mentioned above, could contribute to limiting these negative spill-over effects. The Commission is interested to receive comments regarding this issue.

(62) As regards the avoidance of undue distortions of competition, the Commission strongly doubts that sufficient measures are taken to offset the negative effects of the aid. Indeed, under the new plan, AssetCo will receive a very large amount of aid which will allow it to retain the large majority of NR's assets on a solvent basis and to transfer to BankCo all the [...] assets and liabilities of NR. It will also transfer to it a large amount of cash. As a consequence of all this aid, it seems that BankCo will be a very competitive firm. This bank will not have to support the losses due to all the risky lending made by NR in the past. In addition, it will not have to finance these loans, which is difficult to do on a profitable basis due to increased borrowing costs on the financial markets. Conversely, under the service agreement with AssetCo, it will manage the loans of AssetCo. In other words, it will not have to support the disadvantages of the loans made by NR in the past, but will keep the advantages, namely the contacts with the existing clients. In this sense, it is doubtful that the fact that BankCo will have a small balance sheet is really a measure limiting its market presence and can be considered as a measure which limits the distortion of competition. The Commission would therefore also welcome comments on this point.

(63) The Commission in this context also observes that the amount of aid received by NR is so large that it is not certain that sufficient measures [...] implemented to avoid undue distortion of competition, [...]. [...].

- (64) Furthermore, the Commission observes that some of the most relevant measures which aim to limit the distortion of competition proposed in the original restructuring plan have been amended. Under the new plan, aid is granted to allow the bank to make new loans of GBP 5 billion in 2009 and GBP 9 billion in 2010 (compared to GBP 5 billion each year in the original plan). In addition, NR has ceased the active redemption of maturing mortgages under its redemption programme. This programme, which has been operated by NR since 2008, has had the effect of further reducing the net supply of mortgage loans by NR.
- (65) The Commission acknowledges that in the context of the current financial crisis, a severe reduction of NR's offer of new mortgage loans combined with its active retail mortgage redemption programme, in a period when there is already a general reduction of the supply of loans due to the other banks' difficulties may increase a risk that NR contributes to worsen the situation. However, this does not release NR from the obligation to enact measures which aim to limit the distortion of competition to offset the distortions of competition. The Commission invites the interested parties to comment on this issue and to indicate to what extent a reduction in NR's mortgage lending, taking into account its market share and presence, contributes to the problems on mortgage lending and until when they expect supply of mortgage loans to be constrained. Also, the Commission invites the UK to provide evidence concerning the problems regarding the supply of mortgages to the market.

#### 5. CONCLUSION

- (66) The Commission doubts at this stage that the aid measures included in the new restructuring plan are compatible with the common market. In particular, on the basis of the information available to it, the Commission cannot

ascertain whether the notified aid is limited to the minimum necessary and the distortions of competition outweigh the positive effects of the aid.

#### DECISION

In the light of the foregoing considerations, the Commission has decided to extend the procedure laid down in Article 88(2) of the EC Treaty with respect to the measures notified on 2 April 2009. The Commission requires the UK, within one month of receipt of this letter, to provide in addition to all documents already received, all the relevant information and data needed for the assessment of these measures.

In particular, the Commission would wish to receive comments on the points on which it raised doubts. The UK is requested to forward a copy of this letter to the potential recipient of the aid immediately.

The Commission wishes to remind the UK that Article 88(3) of the EC Treaty has suspensory effect, and would draw your attention to Article 14 of Council Regulation (EC) No 659/1999, which provides that all unlawful aid may be recovered from the recipient.

The Commission warns the UK that it will inform interested parties by publishing this letter and a meaningful summary of it in the *Official Journal of the European Communities*. It will also inform interested parties in the EFTA countries which are signatories to the EEA Agreement, by publishing a notice in the EEA Supplement to the *Official Journal of the European Communities*, and will inform the EFTA Surveillance Authority by sending a copy of this letter. All such interested parties will be invited to submit their comments within one month of the date of such publication.'