EUROPEAN COMMISSION

Brussels, 05.XII.2007
C(2007) 6127 final

**Subject: State aid NN 70/2007 (ex CP 269/07) – United Kingdom
Rescue aid to Northern Rock**

Sir,

1 PROCEDURE

(1) The UK authorities sent documents with background information on 28 September 2007 and 14 October 2007. The Commission sent a request for information to the UK on 16 October 2007 to which the UK replied on 5 November 2007. On 6 November 2007 a meeting was held between representatives of the UK and the Commission services. The UK provided additional information on 19 and 20 October. A meeting between the UK authorities and DG COMP was held on 23 November 2007. The UK authorities notified the measures to the Commission on 26 November 2007.

2 DESCRIPTION OF THE MEASURES

2.1 The Beneficiary

(2) Northern Rock plc (hereinafter "NR") is the 5th biggest UK mortgage bank with a balance-sheet total of £ 101 billion (€ 150 billion as per 31.12.2006), based in Newcastle-upon-Tyne. In 2006, its interest income represented £ 5 billion, with a profit of £ 443 million. The bank was formed in 1997 when the former mutual financial institution (Building Society) was converted and floated on the London Stock Exchange. Shares were distributed to its members who held savings accounts and mortgages with them. That is why, among its shareholders, it has a large number of small shareholders, in total 176,000, who include customers and many of its 6,000 staff. NR has 77 branches throughout the UK, and a limited presence in Ireland and Denmark. NR does not belong to a larger group.

(3) Residential mortgage lending is NR's core activity. It represents more than 90% of all outstanding loans. NR's lending has significantly increased over the last 8 years. The

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bank roughly trebled its share of the UK mortgage market over that period. Whereas retail funds and deposits constituted the main source of financing for the bank in 1998, it has financed the growth of its lending mainly via wholesale funding and in particular by securitisation of its assets. Therefore, the structure of its liabilities changed and in the last years, unlike most UK banks, NR financed the majority of its long-term mortgage loans by issuing securitised notes.

2.2 Northern Rock's financial difficulties and the events triggering the measures

(4) As a consequence of the ongoing turbulence in the world's financial markets, a significant rationing of funds in the sterling money markets occurred and the mortgage securitisation market virtually closed. This has created severe liquidity difficulties for NR whose business model is particularly reliant on frequently raising finance in the financial markets.

(5) From 17 August, NR was in contact with the Tripartite authority via the Financial Services Authority (hereinafter "FSA") which was aware of the increasing difficulties faced by NR. At that time, the Bank of England (hereinafter "BoE") made clear to NR that any emergency liquidity assistance would be granted once it is confirmed that no private investor solution would be possible[1].

(6) NR explored all possible financing options without success. By the beginning of September, it also looked for a purchaser, but […] [*].

(7) NR was unable to meet its funding needs as of 13 September. There was a risk of it having to go into administration. NR, therefore, requested the support of the BoE for an emergency liquidity assistance pending a longer term solution for its current difficulties[2].

(8) The BoE has set out the framework for its operations in the sterling money markets in the so-called Red Book[3]. In order to grant the requested liquidity assistance to NR the BoE needed to deviate from the framework and, hence, to obtain an authorisation in accordance with the Memorandum of Understanding[4]. The provision of liquidity support was authorised by the Chancellor of the Exchequer on the basis of the BoE's advice.

(9) On 14 September the BoE granted emergency liquidity assistance to NR. The difficulties of NR were further aggravated by a bank-run, which started after the news

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[1] Several factual elements in this decision are corroborated by the following source of information: Transcripts of oral evidence of 20 September 2007, 9 October 2007, 16 October 2007 and 25 October 2007 of the Treasury Committee of the House of Commons and the Financial Stability Report of the Bank of England, October 2007, p 10-12.

[*] Confidential information, marked by […] also below.

[2] Financial regulation in UK is ensured by the "tripartite" system in which the Bank of England, the Financial Services Authority (FSA) and the HM Treasury have different responsibilities as set out in the Memorandum of Understanding between HM Treasury, the Bank of England and the FSA of 22 March 2006.

[3] The Red Book framework is designed to implement the interest rate decisions of its Monetary Policy Committee. The Memorandum of Understanding (see footnote 2) acknowledges that in exceptional circumstances there may be a need for operations in the money markets (in particular, in case of emergency liquidity assistance) which go beyond the Red Book framework. In such cases ultimate responsibility for authorisation of the operation rests with the Chancellor under paragraph 14 of the MoU.

[4] See footnote 2.

on the BoE granting support to NR was made public (due to a leak to the press one day before granting and publicly announcing the measure). In order to stop it and avoid contagious effects leading to a wider banking crisis, the Treasury announced guarantee arrangements for all existing accounts in NR on 17 September 2007. Further, the HM Treasury clarified the assumed liability guarantee backed by State resources via a publication on HM Treasury's website on 20 September 2007.

(10) By beginning of October NR […]. Therefore, on 9 October 2007, the Treasury extended the guarantee to new retail deposits and, together with the BoE, modified the terms and conditions of the emergency liquidity assistance.

2.3 The Measures

2.3.1 Bank of England's liquidity facility granted on 14 September 2007

(11) The emergency liquidity assistance was provided by the Bank of England and took the following forms: *i)* loan facilities against a charge over mortgage loans (the "*Loan Agreement*") and *ii)* a repurchase facility in respect of securities (the "*Repo Facility*"). The facilities were uncommitted and repayable on demand, but in any case not later than on the final repayment date of […].

(12) Each draw down of the funds required the provision of high quality collateral or securities or the sufficiency of collateral or securities already provided and the BoE being assured of the FSA's satisfaction as regards NR's continued compliance with the prudential requirements.

(13) The facilities under the Loan Agreement were secured by unsecuritised residential mortgage loans. Eligible securities for the Repo Facility collateral included […]. In addition, margins (the so-called "haircuts") were applied to collateral provided for the facilities to protect the BoE against the risk that the price of collaterals falls when it is realised after the default of the counterparty (NR). According to the UK authorities, the value of the collaterals is adjusted daily. In its valuation, the BoE applies its standard methodology and is averse to risk taking in an equivalent way it does in normal monetary operations.

(14) The rate of interest is […] % for both facilities. It is fixed at […] bps over BoE's official rate (5.75%), which is […] bps above the rate of the Bank of England's standing facility with the financial markets. Hence it is above the reference rate for the UK[5].

2.3.2 State guarantee for existing accounts granted from 17 to 20 September 2007

(15) The guarantee arrangements granted on 17 September 2007, the terms of which were clarified on 20 September 2007, cover all accounts existing at midnight on 19 September 2007 in Northern Rock, including new deposits into existing accounts. The guarantee also covers accounts closed between 13 and 19 September and subsequently re-opened. In order to safeguard Northern Rock's access to the wholesale markets, the Treasury guaranteed also the "existing and the renewed wholesale deposits" and "existing and the renewed uncollateralized wholesale borrowing". Therefore, the guarantee also covers deposits held in Northern Rock by financial

[5] The reference rate for the UK was 5.9% since 1 of September and is 6.83% since 1 October 2007.

institutions, as well as senior unsecured medium-term notes, commercial paper and certificates of deposit.

(16) These State guarantee arrangements are without any fee and formally not limited in time (the UK has communicated to the public that the guarantee will remain in place during the current instability in the financial markets).

2.3.3 The extension of the Bank's of England liquidity facility as restated on 9 October 2007

(17) At the request of the Treasury additional funding facilities were made available on 9 October 2007 by the BoE to NR.

(18) The facilities under the amended loan agreement consist of:
- Facility A – restatement of the facility made available under the original loan agreement;
- Facility B – an uncommitted secured revolving loan and/or overdraft working capital facility;
- Facility C – an uncommitted secured standby revolving loan trust facility;
- PIK Interest Agreement – roll-over of part of interest due.

(19) HM Treasury has undertaken to indemnify the BoE against liabilities that might arise from BoE's role in the Facilities A, B, C and the PIK Interest Agreement.

(20) The loan agreement of 14 September is now re-characterised as Facility A advances under the restated Loan Agreement of 9 October. However, no advances can be drawn anymore under facility A since […] and since it is not permitted to do so anymore under the restated Loan Agreement. The UK Treasury indemnity applies only to possible losses arising after 9 October 2007.

(21) Facilities B and C and the PIK Interest Agreement are not secured by any specific collateral.

(22) The advances drawn under Facility B are restricted to […]. Facility B can also be used to […].

(23) Facility C is to be used […].

(24) The final repayment date for all three facilities (A, B and C) is […]. The rate of the interest is […] bps over BoE's official rate. In addition, NR is required to pay a facility fee of […] % on the difference between the maximum and average principal amounts outstanding during the life of the facilities.

(25) Under the terms of the PIK Interest Agreement, the […] bps margin element of the interest accruing after 9 October under the revised agreement (all facilities) is rolled up and subordinated[6] for 5 years in order to qualify as capital under capital adequacy requirements (so called PIK facility). Such rolled over amounts will bear the same interest rate (BoE official rate + […] bps). The terms and conditions of the subordinated loans are the minimum necessary in order to qualify as TIER II capital and therefore to ensure that Northern Rock satisfies the prudential requirements in the nearest future. Without this, […].

[6] It is payable only after NR's other unsecured and unsubordinated creditors have been paid in full. However there are certain exceptions and if NR receives certain forms of capital it is in fact obliged to repay this subordinated loan.

(26) The Repo Facility is still in place and was not amended on 9 October 2007. It is said to be governed by the BoE's standard terms and conditions and operating procedures for repurchase transactions. According to the terms of the Repo Facility, the eligible securities are effectively transferred to the BoE at the time of purchase, so it has title to the securities and is entitled to sell them if NR fails to pay on the repurchase day. […]. The indemnity granted to BoE by HM Treasury also covers the Repo Facility as of 9 October 2007.

2.3.4 State guarantee on new accounts on 9 October 2007

(27) The HM Treasury extended the guarantee on 9 October 2007 to cover all new retail deposits made after 19 September 2007, which were not covered by the initial arrangements. A guarantee premium of […] % per annum will be paid on the aggregate amount of the new retail deposits accepted during the period from 9 October 2007 till the Final Repayment Date.

(28) The fee is paid to the BoE but for the account of the HM Treasury. The guarantee is aimed to remain in place during the current market instability and until the HM Treasury gives reasonable notice to the depositors that such arrangement will be terminated.

3 POSITION OF THE UK

(29) The UK authorities claim that the measure implemented on 14 September 2007 was a liquidity assistance whose risk was solely borne by the BoE, taken autonomously from the government and should thus not constitute aid. However, the UK authorities accept that the guarantees granted on 17 to 20 September 2007 as well as the further measures granted on 9 October 2007 contain State aid elements.

4 ASSESSMENT

4.1 Existence of State Aid

(30) Article 87 (1) EC Treaty 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.

(31) As regards the measures implemented on 14 September 2007 the following elements have to be considered.

(32) The measures were taken by the UK's central bank to provide a temporary liquidity support to NR, in the absence of its normal sources of funds in the sterling money markets. This was done at a moment when the bank was solvent. This facility was secured against high quality collateral, to which "margins" ("haircut") were applied against the risk of falls in the price of the collateral, which is assessed on a daily basis, and against a penal interest rate, which was above the rate applied to its standing facility.

(33) The measures were taken at the BoE's own initiative. The measures were the first intervention by the authorities and were therefore taken independent of and before the other measures.

(34) In these circumstances, the Commission considers that these measures of 14 September do not constitute State aid within the meaning of Article 87 (1) EC Treaty.

(35) The Commission considers, in line with the position of the UK, that the measures taken from 17 to 20 September 2007 as well as all the measures decided on 9 October 2007, constitute state aid pursuant to Article 87 (1) EC Treaty. The Commission considers that these measures constitute state aid since they fulfil all conditions laid down in Article 87 (1) EC, and in particular no market economy investor would have granted any such measures.

4.2 Compatibility of the aid with the common market

(36) The aid falls to be assessed as ad hoc aid by the Commission. Article 87 (3) EC Treaty provide for exemptions to the general incompatibility stated in Article 87 (1) EC Treaty.

4.2.1 Compatibility under 87 (3) (b) EC Treaty

(37) As regards the first part of the exemption, it is not applicable at the case at hand. The aid does not promote the execution of an important project of common European interest.

(38) As regards compatibility under the second part of Article 87 (3) (b), it is the Commission's practice to consider that an aid benefiting one operator or one sector only could not address the kind of situation targeted by this clause. In the *Crédit Lyonnais* case[7], where the bail out measures were worth around € 20 billion, the Commission did not consider that the aid was "designed to remedy serious economic disruption, since its purpose is to resolve the problems of a single recipient, *Crédit Lyonnais*, as opposed to the acute problems facing all operators in the industry." It should be noted that the business model of NR was considered as "*extreme*" due to its heavy dependence overall on wholesale funding[8]. Furthermore, the UK Authorities argue that a systemic crisis might have arisen due to the reaction of the market and the behaviour of the depositors once the liquidity support granted by the BoE was made public. However, the Commission estimates that based on the information provided by the UK authorities there is not sufficient ground to conclude that way.

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7 Commission Decision of 20 May 1998 concerning aid granted by France to the Crédit Lyonnais group, published in OJ L 221 of 08 August 1998, page 28.

8 See question 201 of the transcript of oral evidence to the House of Commons Selected Treasury Committee of 9 October 2007.

4.2.2 Compatibility under 87 (3) (c) EC Treaty and the 2004 Rescue and Restructuring guidelines

(39) As regards compatibility under Article 87 (3) (c) EC Treaty the measures have to be assessed under the Community guidelines on State aid for rescuing and restructuring firms in difficulty[9] (hereinafter "the Guidelines").

(40) For the purposes of this analysis, the Commission proceeds on the basis of the information provided by the UK authorities.

Eligibility of the company

(41) Point 2.1 of the Guidelines defines a firm in difficulty. The UK authorities assert that NR would fulfil the criteria under domestic law for being the subject of collective insolvency proceedings if it were not for the measures granted by the BoE. The Commission agrees with this statement. According to point 10 (c) of the Guidelines, NR thus automatically qualifies as a firm in difficulty.

Form, interest rate and other conditions for rescue aid pursuant to point 25 of the Rescue and Restructuring Guidelines

(42) The aid fulfils all five conditions for a compatible rescue aid stipulated in point 25 of the Guidelines:

(43) First, the aid must comply with the conditions of point 25 (a) of the Guidelines, according to which any loan must be reimbursed and any guarantee ended within a period of not more than six months after the disbursement of the first instalment to the firm. An exception may however be made from the restriction as to form of rescue aid in the banking sector[10], in order to enable the credit institution in question to continue temporarily carrying on its banking business in accordance with the prudential legislation in force. Notwithstanding this, aid granted in the form other than loan guarantees or loans fulfilling the conditions in point 25 (a) should fulfil the general principles of rescue aid and cannot consist in structural financial measures related to the bank's own funds.

(44) In the case at hand, all the measures are in the form of loans and guarantees. As regards the State guarantees on deposits, the deposits at issue are the source of financing provided to NR by its clients. It is therefore a liability for the bank. Hence, in this case, the Commission considers that guarantees on deposits can be assimilated to guarantees on loans.

(45) As regards duration, in the case of Facilities A, B and C, the Commission notes that the BoE is entitled to demand repayment of all or part of the loans on any date. In the case of the guarantees, no formal date has been set for their end. However, since in addition the UK authorities have undertaken in accordance with point 25 (c) of the Guidelines to notify by 17 March 2008 (6 months from the implementation of the first State aid measure) a restructuring or liquidation plan for NR or proof of full reimbursement of the loans and cessation of the guarantees, the Commission considers that these measures fulfilled the time limit of the guidelines.

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9 OJ C 244, 1.10.2004, p. 2.

10 See footnote to point 25(a) of the Guidelines.

(46) In the case of the PIK Interest Agreement, the measure provides for interest payments on the other facilities (and also on the accrued interest on the PIK facility itself) to be rolled up for five years, and subordinated to the other debts for the same length of time. Its provisions therefore could result in its continuation beyond the six month limit. However, the Commission has noted that:

(i) this measure is also covered by the undertaking from the UK authorities referred to above;

(ii) the measure allows for early repayment in certain circumstances. Indeed, where NR raises any money by way of securities or a loan or other transaction that qualify as Tier I or Tier II instruments, it must make an early repayment of the accrued interest on the amended loan and then of amounts outstanding under the amended loan agreement;

(iii) a subordinated loan is a reversible measure that may be considered not to be a "structural" measure since it can be reimbursed at any time by NR. Conversely to a capital injection or a grant, a subordinated loan has to be reimbursed by the borrower (i.e. NR). In addition, subordination for 5 years is the minimum to enable the company to continue to satisfy the prudential requirements, given that its 5-years duration complies with the minimum requirement of the EC directive EC 2006/48/EC of the European Parliament and the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions[11] to be qualified as Tier II capital. This is exactly the purpose of the exception for banks referenced above, and is therefore the least "structural" possibility serving the purpose in the sense of the footnote to paragraph 25(a) of the guidelines. Its terms also respect the general principles of rescue aid.

(47) The Commission has therefore concluded that all the measures fulfil the conditions as regards to the form and duration. Nonetheless, the footnote of point 25 (a) states that "*[a]ny aid granted in a form other than loan guarantees or loans fulfilling the conditions set out in point (a), will be taken into account when any compensatory measures under a restructuring plan are examined in accordance with points 38 to 42*." Therefore, in the event that the UK authorities present a restructuring plan, the Commission will take into account the PIK interest agreement when examining compensatory measures in accordance with points 38 to 42 of the Guidelines.

(48) Point 25 (a) requires also that the loans must be granted at an interest rate at least comparable to those observed for loans to healthy firms, and in particular the reference rates adopted by the Commission. The Commission observes that this condition is fulfilled for the loans granted by the BoE. As regards the State guarantees on the deposits, the Commission observes that these guarantees do not diminish the cost of funding for NR below that of healthy banks. NR continues to pay the normal interest rates to the various categories of lenders and depositors and to bear respective administrative costs. It therefore complies with the condition of the Guidelines that the interest rate is "at least comparable to those observed for loans of healthy firms". In line with the Commission practice[12], even though the remuneration might be under the reference rate adopted by the Commission, since the cost of financing of NR is at least comparable to the one of a healthy firm one the measures have been granted, the Commission considers that this condition is fulfilled.

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11 OJ L 177/1, 30.06.2006

12 See Commission Decision of 26 September 2006 in case NN 16/2006, concerning rescue aid to CIT.

(49) Second, the aid is in line with point 25 (b) of the Guidelines warranted on the grounds of serious social difficulties and has no unduly adverse spill-over effects on other Member States. On the one hand, since the alternative scenario would have lead to the bankruptcy of NR which may have led to job losses, the aids were justified on the grounds to avoid serious social difficulties. On the other hand, since the liquidity facility granted is constructed so that NR every time receives only the cash needed for a week ahead and is also committed to the service deed agreement of 9 October 2007, it can be argue that NR cannot behave aggressively on the market. The Commission considers therefore that the condition concerning the absence of unduly adverse spill-over effects is fulfilled.

(50) Third, in line with point 25 (c) the UK authorities have undertaken to communicate within six months from 17 September a restructuring or liquidation plan for NR or proof of full reimbursement of the loans and cessation of the guarantees.

(51) Fourth, the amount must be the minimum necessary to keep the firm in business for six months as stipulated in point 25 (d) of the Guidelines. In the case at hand, the liquidity assistance is based on the liquidity needs of the company. Given that the liquidity facility granted is constructed so that the company every time receives only the cash needed for a week ahead, and that the BoE carries out a control on the use of the liquidity, the Commission considers that this condition is fulfilled.

(52) Finally, the UK authorities confirm that NR has not benefited from any rescue or restructuring aid in the last ten years. Therefore the notified aid complies with the 'one time, last time principle' as set out in points 72 et seq. and point 25 (e) of the Guidelines.

4.2.3 Conclusion on the compatibility

(53) From the foregoing analysis, it turns out that the aid measures implemented as of 17 September 2007 constitute compatible rescue aid.

5 DECISION

The Commission concludes that the measures taken from 17 to 20 September 2007 as well as the measures decided on 9 October 2007 constitute State aid pursuant to Article 87 (1) EC Treaty. As the UK has thus put aid into effect in breach of Article 88 (3) EC Treaty, the aid measures constitute non-notified State aid.

As these measures are however compatible with the Common Market as rescue aid pursuant to Article 87 (3) (c) EC Treaty, the Commission raises no objection against them.

The Commission expects your authorities to respect their commitment to communicate to the Commission, not later than 17 March 2008, a credible and substantiated restructuring plan or a liquidation plan or a proof that the aid measures granted have been repaid in full and that the guarantees have been terminated.

The Commission underlines that the aid is authorised until 17 March 2008 or, where your authorities have submitted a credible and substantiated restructuring plan within that period, and the Commission does not decide otherwise pursuant to point 26 of the Guidelines, until the Commission reaches its decision on the plan. The Commission reminds your authorities that it will pursue any measure (including the PIK Interest Agreement) and aim at its reimbursement to the extent that it remains in place beyond the approved period and cannot be found compatible with the Common Market.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site:

http://ec.europa.eu/community_law/state_aids/index.htm..

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Yours faithfully,

For the Commission

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