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DEBATE PACK

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Purchase of Distressed Assets by Cerberus

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Summary

George Kerevan will introduce a Westminster Hall debate about the role played by the Cerberus financial group in the sale of the nationalised assets of UK banks following the financial crash of 2007. The issue of the disposal of assets has been returned to on numerous occasions by the Treasury Select Committee and there has been a broadly favourable Report into the sale by the NAO. It focuses particularly on the purchase of the assets of the previous Northern Rock Bank.

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1. Background

Summary

George Kerevan will introduce a Westminster Hall debate about the role played by the Cerberus financial group in the restructuring of the nationalised assets of UK banks following the financial crash of 2007. This issue has been returned to on numerous occasions by the Treasury Select Committee. It focuses particularly on the purchase of the assets of the previous Northern Rock Bank.

The sale was looked at by the National Audit Office who commented that:

> In November 2015 the government disposed of £13.3 billion former Northern Rock mortgages and loans to a consortium led by US private equity group, Cerberus. According to a report today by the National Audit Office, when judged against the Government's objective to shrink the balance sheet swiftly the deal was value for money. This transaction represents the government's largest-ever financial asset sale.
>
> The sale, conducted by the UK Asset Resolution (UKAR) which is owned by HM Treasury, comprised of £11.9 billion of mortgages from the Granite debt financing vehicle within Northern Rock Asset Management (NRAM) and additional loans (£1.4 billion). The taxpayer received £5.5 billion in cash while Cerberus took on nearly £8 billion in liabilities. Some 270,000 mortgages and loans were sold in the deal.

The NAO Report can be found here.

1.1 Introduction

The very first striking image of the financial crash were the orderly queues of Northern Rock customers standing and chatting in the sunshine in Newcastle streets, waiting to withdraw their money. It was a very British 'run on the bank'.

In the subsequent days and months, Northern Rock received an emergency £25 billion loan and government guarantees about the security of deposits reduced the queues of depositors to a trickle.

Following the failure to find a private sector buyer for the whole bank, and the consequent nationalisation, further losses persuaded the Treasury to split it into a good and bad bank.

The Government injected £1.4 billion of equity to Northern Rock plc to capitalise the bank at inception. This was the 'good bank'. It was sold to Virgin Money on 1 January 2012.

Northern Rock (Asset Management) plc (NRAM) was the 'bad bank'. It comprised the 'closed mortgage book'. As of 1 January 2010, total assets of the company were around £75 billion, of which £54 billion were mortgages and unsecured loans to customers. It was never an active lender or deposit taker. As of 1 January 2010, the Government loan stood at £22.8 billion.

In July 2012, Virgin Money bought a substantial tranche of NRAM mortgages from UKAR.[1]

On 13th November 2015 UKFI announced a further significant sale of NRAM mortgage assets:

> UK Financial Investments Limited (UKFI), today confirms that following a competitive sales process, UK Asset Resolution Limited (UKAR), the holding company for the government owned businesses of Bradford & Bingley plc (B&B) and NRAM plc (NRAM), has agreed to sell a £13bn portfolio of NRAM mortgages and unsecured loans to affiliates of Cerberus Capital Management LP. The proceeds include a c. £280m premium over book value. The sale brings the total UKAR balance sheet reduction to £73.5bn (63%) since formation in 2010 and means that the government has now exited over 85% of Northern Rock.[2]

A final payment of £520 million in respect of this transaction was received in May 2016. It is this sale which is the focus of the debate.

1 UKFI press release 23 July 2012
2 UKFI press release 13 November 2015

2. The sale to Cerberus.

2.1 Who are Cerberus

Cerberus is

> ONE OF THE WORLD'S LEADING PRIVATE INVESTMENT FIRMS.
>
> Cerberus Capital Management, L.P. is a private investment firm based in New York City with affiliate and advisory offices across the United States, Europe and Asia. With over $30 billion under management, we manage funds and accounts for many of the world's most respected investors.[3]

It has four main areas of investment, one of which is 'distressed securities and assets'. One part of this is 'mortgage backed debt and securities' of which it says:

> Cerberus is a proven expert in both residential and commercial mortgage-backed securities investing. Our Real Estate, RMBS, and CMBS investment professionals have decades of experience managing whole loans, liquid products, servicing and securitization. This experience guides their use of the firm's broad set of resources, giving us a competitive edge in identifying, evaluating and acting on pricing inefficiencies in the MBS markets.
>
> Drawing on their deep expertise, Cerberus Real Estate RMBS and CMBS teams are able to:
>
> Restructure downgraded securities to improve returns
>
> Construct portfolios with diversified credit and structure profiles
>
> Adjust exposure to sectors to outperform market expectations.[4]

The company has bought other loan books, including from RBS, Lloyds and National Australia bank. It declined to appear at a committee of the Northern Ireland assembly to answer questions about its purchase of £1.2bn of loans from Ireland's National Asset Management Agency.

2.2 Purchase of distressed assets by Cerberus Capital Management

£13.3 billion of NRAM mortgages were sold for £5.5 billion, cash. Cerberus took on nearly £8 billion in liabilities. Some 270,000 mortgages and loans were sold. There were two strands of interest in the sale, first was it a 'good deal' for the taxpayer and secondly how would mortgage holders be treated by the new owner.

Value for Money?

The main source of material concerning how the sale was conducted is the review by the National Audit Office. Its summary comments are shown in full below:

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[3] Cerberus website
[4] Cerberus website

Government's objective to shrink the balance sheet swiftly the deal was value for money. **This transaction represents the government's largest-ever financial asset sale.**

The sale, conducted by the UK Asset Resolution (UKAR) which is owned by HM Treasury, comprised of £11.9 billion of mortgages from the Granite debt financing vehicle within Northern Rock Asset Management (NRAM) and additional loans (£1.4 billion). The taxpayer received £5.5 billion in cash while Cerberus took on nearly £8 billion in liabilities. Some 270,000 mortgages and loans were sold in the deal.

The sale price exceeded UKAR's valuation of the assets which was in line with its adviser but based on some conservative assumptions. It achieved a sale price of £74 million (0.6%) above the face value of the loans and £450 million (3.6%) above UKAR's valuation. The cost of equity assumption UKAR used gave their estimate a conservative bias. The UK Financial Investments Ltd (UKFI) challenged these assumptions and came up with a valuation that was closer to the winning bid (the top end was £94 million, or 0.8% below the winning bid). With hindsight it can be seen that bidders used more aggressive assumptions than UKAR and UKFI.

While preparing and carrying out other transactions, investors expressed interest in buying Granite – a larger asset pool than UKAR had considered selling. Granite's mortgages were attractive to investors as they offered a good yield (85% of the mortgages pay above 4.5% interest). However they also had a higher loan-to-value and arrears ratio than the market average. UKAR, UKFI and HM Treasury reacted quickly and obtained relevant approvals to pursue this opportunity. There was no single asset disposal strategy document or single business case to consider the evidence supporting the option chosen against alternatives.

The scale of this sale limited the number of potential bidders but good competitive tension was maintained through the sales process. UKAR addressed concerns about scale by reducing the financing risk of bidders. Granite had around £8 billion of financing in place, which a buyer could take on requiring it to raise only £5 billion of funding. This was particularly attractive to private equity buyers, who are more reliant on third party funding than banks, who can also use customer deposits. All final round bidders were in the end comfortable to refinance Granite's funding structure and raise over £12 billion of finance.

UKAR identified an alternative sale option which achieved a higher theoretical valuation than the option chosen but in their view would have been at the expense of slower balance sheet reduction and greater delivery and market risk. UKAR estimated that multiple, smaller transactions would have increased the asset's valuation by up to £300 million, but would have taken up to 27 months longer to complete. Adjusting this valuation for the market execution risk, UKAR and UKFI estimated the increase only to be £98 million with potential further downside risk which it considered outweighed any potential benefit of delay. UKAR also stated that it did not have the staff capacity to run multiple concurrent transactions.

The sales process was well run. The deal took 18 months from appointment of advisers to final close in May 2016. The number of bidders at each stage, the convergence of bid prices, the willingness of bidders to incur high transaction costs, and their

> acceptance of key terms and conditions of the sale agreement, was evidence of competitive tension. The bids reduced between rounds one and two but this was primarily because of worsening market conditions rather than a lack of competition.
>
> **The limited degree of competitive tendering in UKAR's procurement process was not good practice**. The financial adviser, Credit Suisse, was involved in the early phase of the programme to sell its mortgage servicing operation on a pro-bono basis and subsequently won a tender against a small number of preselected competitors. During the process, their scope and fee were increased from £2 million to £4.5 million to reflect changes in the transaction. The changes included permitting the adviser to act as financing bank to bidders. Due to a potential conflict of interest, this was not permitted under previous sales. UKAR permitted it this time because it felt the size of the transaction required the availability of all major players in the securitisation market to facilitate the financing.
>
> **Customers who have loans and mortgages which were sold in the transaction have been well protected in the short run including restrictions to changes in the interest rate of their mortgages for 12 months**. In the longer term, UKAR relies on Financial Conduct Authority (FCA) regulation to protect customers. While the mortgages and loans are currently owned by FCA-licensed entities, they, like any UK mortgage, could be sold in the future to an entity which is not regulated and customers would need to seek redress under the Consumer Rights Act.[5]

The full NAO Report can be found here.

Treatment of customers

Some concern was raised about how Cerberus would treat people whose mortgages they now held. However, in general the terms and conditions of the loans would not alter – at least in the short run. An article from the Guardian at the time of the announcement quoted the head of UKAR on the changeover:

> Richard Banks, chief executive of Ukar, said it could be the first time some customers realise their mortgage was not with Northern Rock. "They will get what we describe as a goodbye letter from Northern Rock Asset Management and a hello letter from Cerberus or TSB," he said.
>
> Banks said under the terms of the deal Ukar's mortgage servicing division would continue to manage the loans, adding that it would be "business as usual" with no changes to customers' terms and conditions. The mortgage servicing division employs about 1,800 people and is up for sale.

However, the same article quoted the Union Unite's representative as saying:

> Unite's regional officer, Brian Cole, said: "It's alarming to see the mortgages of so many homeowners being sold-off to an equity firm whose only interest is short-term profit. Our members and the thousands of homeowners who rely on us deserve long-term security, yet once again their futures are being placed on the roulette wheel."

5 NAO Press Release July 2016

And another view was that "Changes must be expected as a result of the change in ownership," said Stephen Rosen of Collyer Bristow. "In Scotland, for example, we have found that Cerberus is tougher in enforcing breaches in covenants."

In general the people with mortgages subsequently owned by Cerberus were not in a very good position before the sale took place. By definition the 'bad bank' held the 'bad mortgages'. Bad in this context often meant in arears or where there was negative equity – the mortgage was larger than the value of the house it supported. A combination of over generous lending and the post-crash fall in house prices left many mortgage holders 'trapped'.

When Northern Rock collapsed and the government took it over, Northern Rock ceased to be a 'competitive' market operator at that point. It was not an organisation looking to win greater market share of loans or accounts. Instead, the job of the UK Asset Resolution Management – the holding company for Northern Rock, was to find a way of realising the greatest part of the government support by selling the assets of the bank.

This state of affairs meant that long term customers of Northern Rock, mainly mortgage holders, were now with a bank that had little incentive to compete on price for mortgage business and in fact would be best served by having no mortgage business at all.

Worse, the state-rescued Northern Rock cannot be a competitive mortgage lender even if it wanted to. All forms of state assistance given to the banks when they were rescued had to pass the EU Commission's state aid rules. This would not allow the state to nationalise a lender and then act as a normal bank. The assistance was permitted on the condition that the bank, or most of it, could be returned to the private sector and that the rump would simply be a holding exercise until loans were paid off.

Whilst the then owners of NRAM – UKAR – were charged with realising the most from the asset book they have inherited to repay the government loan facilities that kept the bank afloat (formally, this is set out in the 2012 *Annual Report and Accounts* of NRAM.[6] The company did acknowledge the difficult position that mortgage holders may have found themselves in and the NRAM website carried on it general advice for its mortgage holders. This can be found here.

Many constituents wrote to their MPs complaining about the circumstances they found themselves in. Did their position worsen after Cerberus took over? According to an FT article (13 November 2015) about 90,000 mortgages were passed to Cerberus – the rest to TSB. One point to make would be that generally speaking economic conditions have improved. Interest rates remained low and house prices have risen – unequally across the country but still generally risen.

6 NRAM Report and Accounts 2012, p3

There appears to be no published data which systematically compares the treatment of mortgage holders before and after the sale.

One issue of comparability is that Cerberus has positioned itself such that it concentrates upon the high risk end of the mortgage market. In October 2016 it bout 900 mortgages from Ulster Bank, of which "95% of the mortgages are two years or more in arrears, while all of the loans are the subject of legal action by the lender."[7]

[7] RTE News 10 October 2016

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