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Government Guarantee in relation to Northern Rock plc

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Summary

1. The Government's guarantee in relation to Northern Rock plc is classified as a contingent liability for the purposes of National Accounts and Public Sector Finances.
2. Any payments under the guarantee are contingent on an event occurring (Northern Rock plc failing to meet the obligations covered under the guarantee), where there is uncertainty about whether this will occur or not. There is also uncertainty, if it does occur, about when, and the amounts that would crystallise. Contingent assets and liabilities are excluded from the National Accounts, since the accounts cover transactions when they occur (or accrue) and the assets and liabilities that arise from these transactions.

Background

3. On 14 September the Chancellor of the Exchequer authorised the Bank of England to provide a liquidity support facility to Northern Rock plc. On 17 September the Government announced a guarantee scheme for Northern Rock plc. An HM Treasury press release on 20 September gave the following details.

“The guarantee arrangements for existing deposits in Northern Rock plc would cover all accounts existing at midnight on Wednesday 19 September. This guarantee covers future interest payments, movements of funds between existing accounts, and new deposits into existing accounts. The guarantee will also cover accounts re-opened in the future by those who closed them between Thursday 13 September and Wednesday 19 September, inclusive.”

Since it would otherwise be unfair to other banks and building societies, the arrangements would not cover any new accounts set up after 19 September, other than re-opened accounts as set out above.

*In the case of wholesale market funding for Northern Rock plc, the Treasury confirmed that the arrangements would cover:
existing and renewed wholesale deposits; and
existing and renewed wholesale borrowing which is not collateralised.*

The arrangements would not cover other debt instruments including:

- covered bonds;*
- securities issued under the “Granite” securitisation programme; and*
- subordinated and other hybrid capital instruments.*

The guarantee in relation to Northern Rock plc will remain in place during the current instability in the financial markets.”

National Accounts Classification of Guarantees

4. For National Accounts purposes guarantees are classified as contingent assets and liabilities and are excluded from the National Accounts, as described below (*European System of Accounts 1995*, paragraph 5.05):

5.05 Contingent assets are contractual arrangements between institutional units, and between them and the rest of the world, which specify one or more conditions which must be fulfilled before a financial transaction takes place. Examples are guarantees of payment by third parties, letters of credit, lines of credit, underwritten note issuance facilities (NIFs) and many of the derivative instruments. In the system, a contingent asset is a financial asset in cases where the contractual arrangement itself has a market value because it is tradable or can be offset on the market. Otherwise, a contingent asset is not recorded in the system.

5. Any liability, such as Northern Rock plc’s liability to pay its depositors or repay borrowing from the money market, thus remains classified as a liability of the debtor (i.e., Northern Rock plc) while there is no call on the guarantee.
6. The calling of a conventional government guarantee involves transferring the liability (or part of it) from the debtor to the government. The exercising of a guarantee is reflected in National Accounts by a notional capital transfer from government to the debtor, for the size of the amount called, with an offsetting notional sale of the liability from the debtor to the government in the financial account. The capital transfer affects public sector net borrowing, and the new debt on government’s financial balance sheet is included in public sector net debt.

Securitisation

7. Eurostat's *Manual on Government Deficit and Debt* covers guarantees of securitisation operations. The manual looks at the presence of guarantees in the context of an assessment of risk transfer in deciding whether a true sale from the originator to a Special Purpose Vehicle has taken place. The presence of government guarantees in securitisations usually leads to reclassification of the operations as government borrowing. In the UK the effective government guarantee of a London & Continental Railways securitisation led to the amounts borrowed being classified as government borrowing.
8. Northern Rock plc has a securitisation programme known as 'granite'. The Treasury's press release states that "the arrangements would not cover other debt instruments including securities issued under the 'Granite' securitisation programme."