Funding the Future

Northern Rock: ten years on

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It is ten years ago today that Northern Rock failed. I will be speaking at a Tax Justice Network organised event at the Royal Society of Arts this evening to mark the occasion.

I have particular association with what happened at the time. I reproduce below what was the first of many blogs that I wrote on the subject. This one was just three days later, making me one of the first people, if not the first person, to ask the questions which eventually were seen as core to this issue on matters such as securitisation, a shadow bank, the use of orphan entities, the abuse of offshore and structuring via special purpose vehicles. Back then most people had never heard of many of these things. Little did they know the price they were to pay for their existence.

Northern Rock is in trouble because it has financed its mortgage book by borrowing commercial money rather than taking deposits from customers. To do that it has issued 'commercial paper'. And now no one wants it.

I've looked at that 'paper'. I'm not surprised no one wants it. Most of this 'paper' is issued through a long series of special purpose vehicles which re named in its accounts. To get some idea look at *this list*:

19. Securitisation

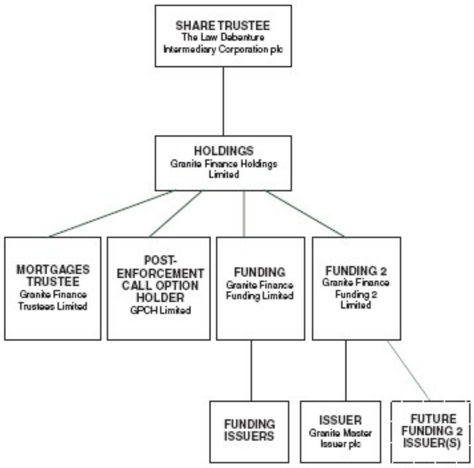
The Group's results include the results and assets and liabilities of securitisation Special Purpose Entities ("SPEs") on a line by line basis. Securitised advances are subject to non-recourse finance arrangements. These loans have been purchased at par by the SPEs from Northern Rock plc, and have been funded through the issue of mortgage-backed bonds. The balances of assets subject to securitisation notes in issue at 31 December 2006 are as follows:

Securitisation company	Date of securitisation	Gross assets securitised £m	Notes in issue £m
Residential:			
Granite Mortgages 99-1 plc	1 October 1999	–	–
Granite Mortgages 00-1 plc	1 March 2000	186.1	170.6
Granite Mortgages 00-2 plc	25 September 2000	330.1	265.9
Granite Mortgages 01-1 plc	26 March 2001	559.2	507.9
Granite Mortgages 01-2 plc	28 September 2001	–	–
Granite Mortgages 02-1 plc	20 March 2002	1,207.7	1,123.6
Granite Mortgages 02-2 plc	23 September 2002	1,417.2	1,302.6
Granite Mortgages 03-1 plc	27 January 2003	1,816.7	1,718.8
Granite Mortgages 03-2 plc	21 May 2003	1,224.2	1,129.0
Granite Mortgages 03-3 plc	24 September 2003	1,154.1	1,058.9
Granite Mortgages 04-1 plc	28 January 2004	1,969.8	1,802.5
Granite Mortgages 04-2 plc	26 May 2004	2,199.4	2,044.6
Granite Mortgages 04-3 plc	22 September 2004	2,549.7	2,378.1
Granite Master Issuer plc	26 January 2005	3,426.4	3,254.6
Granite Master Issuer plc	25 May 2005	3,043.8	2,880.1
Granite Master Issuer plc	31 August 2005	515.5	511.1
Granite Master Issuer plc	21 September 2005	3,013.2	2,840.6
Granite Master Issuer plc	25 January 2006	5,289.7	5,048.1
Granite Master Issuer plc	24 May 2006	2,888.7	2,786.1
Granite Master Issuer plc	19 September 2006	5,643.1	5,400.3
Granite Master Issuer plc	29 November 2006	3,369.5	3,206.2
		41,804.1	39,429.6
Retained interest in Granite Finance Trustees Limited		8,453.2	–
Less cash deposits held with Northern Rock plc		(2,857.4)	–
Total residential		47,399.9	39,429.6
Commercial:			
Dolerite Funding No. 1 plc	24 June 2002	86.7	97.0
Retained interest in Dolerite Mortgages Trustee Limited		48.5	–
Dolerite Funding No. 2 plc	18 July 2005	407.3	414.9
Retained interest in Dolerite Mortgages Trustee No. 2 Limited		198.1	–

That's near enough £40 billion of notes in issue.

Then look at how just one of these is structured through [Granite Master Issuer PLC](). The deal structure diagram looks like this:

Diagram of ownership structure



This diagram illustrates the ownership structure of the principal parties to the transaction:

- Each of the mortgages trustee, Funding, Funding 2 and the post-enforcement call option holder is a wholly-owned subsidiary of Granite Finance Holdings Limited.
- We are a wholly-owned subsidiary of Funding 2.
- The entire issued share capital of Holdings is held on trust by a professional trust company under the terms of a discretionary trust for the benefit of one or more charities. The professional trust company is not affiliated with the seller. Any profits received by Holdings, after payment of the costs and expenses of Holdings, will be paid for the benefit of the Down's Syndrome North East Association (UK) and for other charitable purposes selected at the discretion of the professional trust company. The payments on your notes will not be affected by this arrangement.
- Funding 2 may establish an additional issuer or issuers in the future.

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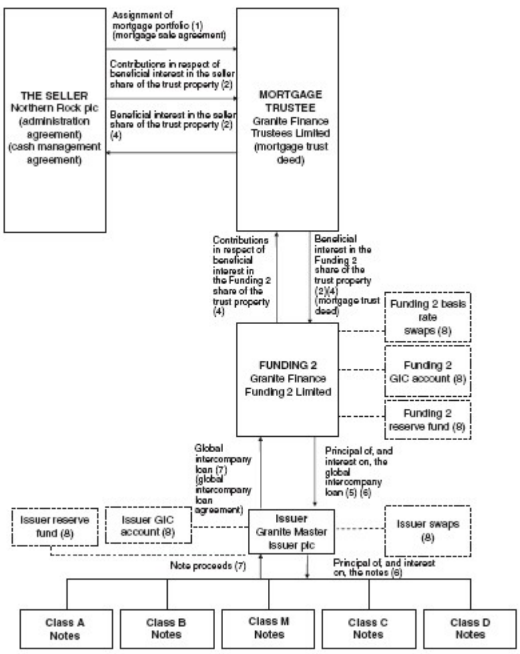
It gets more complicated though. The securitisation structure looks like this:

Structural diagram of the securitization transaction



All of which is a completely prefabricated farce. How can I say that? Take these facts:

1) Note who the share trustee who owns Granite is — it's a Law Debenture Company. This group exists to provide services to special purpose vehicles. No surprise it has offices in London, New York, Delaware, Hong Kong, the Channel Islands and the Cayman Islands.

2) Granite is actually owned by a Law Debenture subsidiary, not by Northern Rock. I've checked.

3) However it does so as trustee — the beneficial ownership is supposedly explained here (it's in the first diagram above as well):

The entire issued share capital of Holdings is held on trust by a professional trust company under the terms of a discretionary trust for the benefit of one or more charities. The professional trust company is not affiliated with the seller.

Any profits received by Holdings, after payment of the costs and expenses of Holdings, will be paid for the benefit of the Down's Syndrome North East Association (UK) and for other charitable purposes selected at the discretion of the professional trust company. The payments on your notes will not be affected by this arrangement.

4) I have a word for this. It is a sham. I can say that because the Northern Rock accounts say:

Basis of consolidation
The financial information of the Group incorporates the assets, liabilities, and results of Northern Rock plc and its subsidiary undertakings (including Special Purpose Entities). Entities are regarded as subsidiaries where the Group has the power to govern financial and operating policies so as to obtain benefits from their activities. Inter-company transactions and balances are eliminated upon consolidation.

In other words that trust is not real. Northern Rock controls Holdings, but pretends not to via complex legal structures for certain purposes to try to avoid some of the risk of ownership arising from doing so, no doubt. Why else do this?

I call this three things:

a) An abuse of the charity involved, who (I stress) need not even have given their assent to be used in this way;

b) A contempt for those who take the real risk on financial markets, which is at the end of the day as this fiasco is showing, you and me and the government;

c) The construction of an arrival device to ensure that as few people as possible, almost certainly the Northern Rock directors included, know just how this deal works. I guarantee you it's a tiny number that do.

And it’s this wholly artificial construction, seeking to shift liability and to avoid responsibility and abusing common sense decency with regard to the abuse of charity to achieve commercial aims that is pulling Northern Rock down.

Of course it’s not alone. This type of deal is constructed ***every day off shore**. It’s the bread and butter of international finance.*

It’s why we can’t trust markets. It’s why regulation is needed. It’s why ownership has to be revealed. It’s why declaring where you’re working is so important. It’s why accountants have once more to put substance over form.

Now I know that for a change these Northern Rock entities were on balance sheet but most aren’t. And can you see as a result why no one will lend inter-bank now? They’ve all been so busy creating these sorts of artifice that no one dare do so — because they all know the warts in their own system, so presume there must be as many in everyone else’s.

It makes me believe, more than ever that the City is rotten to the core. Prove otherwise is my challenge.