

To Northern Rock Shareholders

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Northern Rock Shareholders Action Group – Update No. 9

This is a summary of information since the last update we issued to shareholders.

Information Memorandum Issued

The company is apparently looking at either a sale of the business or a possible restructuring that will involve a partial sale of assets. An information memorandum has been issued to about 50 parties who might be interested and some of the contents of that have been leaked. For example the Daily Telegraph quoted the following from it: **“the most cost efficient bank in the UK”** and a bank whose **“mortgage arrears are less than half the industry average”**. Well at least the company is finally putting its case strongly!

No doubt the company is looking at all the possible options in terms of refinancing to enable it to repay the Bank of England (BoE) funding, and we cannot criticise that. However, there is a concern that assets might be sold off at a discount to their book value to the disadvantage of shareholders. Our last communication pointed out that the net asset value according to the last accounts was £2.3 bn – in other words, about 550 pence per share, which is of course much higher than the current share price. However that net £2.3 bn is the difference between two large numbers – the assets of £113.5 bn and liabilities of £111 bn. If the assets were sold at a discount then the shareholders “equity” would be substantially eroded. Also it is clearly not a good time to try and sell mortgage backed assets as the market is very wary of such investments at present.

You can be assured that the UK Shareholders Association will oppose any restructuring that effectively transfers value from existing shareholders to third parties simply to enable the company to repay Government funding earlier than it might otherwise be able to do so. The Government was primarily to blame for the sequence of events that resulted in the current difficulties as explained below and we don’t see why ordinary shareholders should suffer as a result.

The information memorandum also apparently confirms that retail depositors have withdrawn £10.5 bn of cash since the “run” began, which is about 44% of what they had on deposit from that source. As pointed out in our previous note, this is not particularly unexpected and is not necessarily a problem.

New Mortgage Business

There has been some more negative press comment on the company with respect to the amount of new mortgages it is issuing. For example, it was reported as a "collapse" in one newspaper. Brokers who handle Northern Rock mortgages reported falls of more than 50% and as low as 20% of previous business levels from a few months ago.

It is hardly surprising that when a business is short of cash, and having to borrow money at a rather expensive rate from the BoE, that it does not want to lend it to someone else. So it is clearly prudent for the company to restrict new mortgages that it does issue to good quality customers at a profitable rate of interest. However, it obviously has infrastructure in place to process this kind of business, and it also needs to replace mortgages in the "Granite" mortgage securitisation vehicles that are redeemed. Therefore it does need to continue to issue some new mortgages.

Whose Fault Was the Bank Run?

The Governor of the Bank of England, Mervyn King, and the Chancellor of the Exchequer, Alistair Darling, seem to be giving different versions of what happened prior to the supply of funding by the BoE and the guarantees to depositors. The Governor has finally divulged the tragic errors of assessment and policy execution. As he stated to the BBC, it was a decision for the Government, not the central bank. The truth is probably that (a) HM Treasury advisers did not adequately assess the risks and consequences of saying "no" to a request for a £30 Billion facility to Lloyds TSB at commercial rates when they were considering an offer for the company because they did not appreciate the magnitude or duration of the credit "freeze" and requested a "view" from the Governor, who (b) advised the Chancellor not to agree the facility for Lloyds TSB primarily on the platform of "moral hazard" and the BoE's contrasting approach to "helping imprudent banks". The conclusion has to be that both the Treasury and the BoE got it disastrously wrong. It is clear that following the "run" £30 bn of loans will be provided. It is highly unethical for the Treasury and the BoE to charge penalty interest rates for "lifeboats" that their errors necessitated.

Although Mr King has suggested that the sums involved were larger than other central banks have supplied in funding to ensure liquidity, the whole issue of liquidity rests on confidence, not just the quantity of money. The ECB was able to provide sufficient liquidity to ease the "freeze" in the Eurozone - this came to some 300 Billion Euros. They would have injected more if required, and in fact they fine tuned it from day to day, soaking up any excesses. This is timely, appropriate intervention. A similar approach was used by the Federal Reserve - enough liquidity to maintain market function and restore confidence, no excess. On the contrary, quite aside from injecting liquidity, the BoE repeatedly gave clear signals that they would NOT intervene at all! This destroyed market "confidence" and encouraged UK banks to "hoard" cash and worsened the "inter bank freeze" in the UK. If future support is in doubt, people will hoard! Just like bottles of water during the summer floods: as soon as supply was sufficient people did not hoard anymore.

After the major "U" turn of 19 September only £40 Billion was offered, at punitive interest rates, and the BoE complacently pointed out that there were no takers! The Bank of England should have intervened from 9 August, in concert with the ECB and the FED. Had timely support been "signalled" by the BoE, possibly £70 to £90 Billion of liquidity at competitive interest rates (5.75% maximum) would have prevented the "interbank freeze". If the BoE had accepted the broader classes of collateral and loan duration terms available in the ECB, then Adam Applegarth is absolutely right, lender of last resort would not have to be invoked. The Governor's explanation of the liquidity requirements seems to be simply an attempt to cover up the poor judgement and miserable, piecemeal execution.

As regards the run on the bank, the latest information provided by the Governor suggests that an unconditional guarantee on 13 September (following the BBC leak) or early on the morning of the 14th September when the queues at Northern Rock branches were evident, would have prevented or largely contained the panic. A significant delay resulted though.

Status of our Campaign

We are in essence awaiting details of the proposals that the company may formulate to get it out of its difficulties. In the meantime, if you have not already done so, we suggest you write to your MP to ask them to make representations to the Government on this issue. It is important that the Government does not push the company into precipitate action, even if they have not come up with alternative funding arrangements by the deadline of the end of February.

A few simple lines in your own words asking that the Government provide more reasonable support to the directors of the company is what is required. You should ask that the Government opposes any rapid sale of the business or assets, instead of supporting such a move.

The key points to make are:

- The penal rate of interest being charged by the Bank of England should be reduced (it is important to emphasise that the company is not being “bailed out” – it is being lent money at a high rate of interest).
- There should be no deadline imposed on the provision of support, otherwise the company will have no alternative to proceed with a sale of the business against this prospective deadline. And the outcome of that is likely to be poor for shareholders.

You can write to your MP at the following address: The House of Commons
London, SW1 0AA. If you don't know who your MP is then go to this web site and enter your post code: www.upmystreet.com/commons/l/

Other News

Note that responses from shareholders to our campaign are still coming in and apologies for any slight delay in responding to you – the response rate was higher than we expected and much higher than any other previous campaigns that UKSA has run. In addition we have received quite a number of financial donations to help support this campaign and thanks for those.

Yours sincerely

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