

Subject: Open Letter to the Three Regulators of the UK Banking System

Sirs, the crisis surrounding Northern Rock poses real questions for the future of banking in the UK. The main question concerns asset/liability mismatch. In the fund management business, we understand this well... only invest in less liquid assets if you have a time lock-up from your own investors. However it is surely the main purpose of banking precisely to take short term funding and re-cycle it into long term lending. Arguably it is the most important foundation of a modern, prosperous economy. Nobody who needs a 20 year mortgage, or industrial loan, wants to wait in vain for a 20 year depositor to be found. Therefore, a Central Bank is charged to be lender of last resort because this asset/liability mismatch is always at risk of detonating in the banking system.

In the case of Northern Rock all the published metrics suggest that it has a high quality mortgage book, including a low delinquency ratio and moderate loan to house value ratio. On Basel 2 ratios, Tier One is a healthy 9%. It has also been a good employer and corporate citizen in the North of England and elsewhere, while its shareholder base appears to be mainly ordinary people across the region, not City institutions. It is not obvious why a funding crisis alone, in the absence of poor lending practices, should be allowed to threaten Northern Rock and its shareholders. Moreover, we believe the example of the Federal Reserve is the right way to go. Currently a number of banks are using the Fed's emergency funding window with only a 50bp penalty as opposed to a much higher penalty for Northern Rock. This is on a no names basis and most importantly no time limit is imposed. Even today banks have borrowed anonymously at the ECB's emergency rate. In contrast, the naming of Northern Rock and the implication that a fire sale of its assets might be effectively imposed by a time limit on Central Bank support has threatened to destroy the company.

My conclusion is that much can be learned from the actions of the Fed and also the ECB. It should be of prime importance to all the regulators that an otherwise sound bank does not suffer, except through paying the penalty rate, from a funding crisis in the inter-bank market. Assurance should be given publicly that the bank will be given a considerable period of time to work out its funding problem at a more internationally comparable penalty rate and that no fire sale will be imposed. Finally, a sad ending for Northern Rock and its shareholders would hugely enrich those with large short positions in the stock. It is a new danger for our banking system that shorts can add to the panic in any situation where a bank seeks assistance. It must be a mistake and morally questionable to leave them richer and bolder for the next time.

Philip Richards
Chief Executive
RAB Capital plc
1 Adam Street, London WC2N 6LE
Tel +44 20 7389 7007