

To Northern Rock Shareholders

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Northern Rock Shareholders Action Group – Update No. 19

The Treasury Announcement of the Government's Solution

On Monday the 21st January the Treasury issued a statement that explains how the Government plans to get its money back without nationalising the business. As previously hinted, the plan is effectively to convert the £25bn of loans that the Government has made to the company into bonds that will then be sold in the open market. To make them saleable, the Government will guarantee them.

In reality the company will issue new bonds securitised against some of the assets of the company and will pay the Government a fee for the guarantee they will be providing (which could be as much as £400 million according to some press reports). The cash generated from the sale of the bonds will be used to immediately repay the Bank of England loans.

The structure is such that any losses in the securitised assets (for example as a result of a worsening in the housing market that might lead to significant defaults on the mortgage assets) would fall first on the company before the Government had to bear any losses.

The Government is also asking for an equity stake in the business – between 5% and 10% - so that they can participate in the recovery of the company. The Government hopes that this structure will enable a private sector solution for the company to be found, and have set a deadline of the 4th February for proposals to be put forward, which is a very short time line.

The Treasury Announcement – Other Aspects

The announcement is phrased in very dictatorial terms, as if the Government was trying to sound tough when it knew it might be criticised for being too soft on the company and its shareholders. For example, they make it plain that they will *"have the right, at their complete discretion, to determine which, if any, of the proposals put forward by the company and other interested parties will receive their financial support"*.

They also threw in some gratuitous comments about what happens if no such solution is found and nationalisation has to take place, which we do not think would stand up to scrutiny under European law. We therefore issued the following, somewhat critical, press release which is on our web site (click on the link to read): www.uksa.org.uk/UKSA_Press056_Northern_Rock_Treasury_Terms.pdf, although we are generally happy with the concept proposed.

The plan still needs clearance under EU rules that try to limit state aid, so this is a possible problem but one that it is hoped will not prove an obstruction. In addition the plan is unlikely to affect the Government's public sector borrowing figure as it is effectively solely a guarantee, not actual funding.

Some press commentators called it "partial nationalisation", but this of course is nonsense as the Government will only have a small stake in the business going forward and although there will be some terms associated with the deal, they do not suggest the Government will have substantial control.

Note that the full "term-sheet" that specifies the details of these bonds such as the interest rate payable and redemption date is not yet available and clearly any bidder for the company will have to look carefully at those and the future business plan to ensure that their plans are financially viable and profits are still achievable in the future.

The Reaction of the Various Interested Parties

There seemed to be widespread support for this proposal from the likely bidders, with Richard Branson saying that he was happy with the plan and hinting that he thought he had a good chance of success. Note that there have been some suggestions that as Branson was touring the far-east with Gordon Brown, that this bond plan had been set up specifically to assist Virgin's bid but this seems unlikely. Branson denied even talking about the deal with Brown in private.

Lugman Arnold of Olivant also sounded hopeful of being able to submit a proposal by the 4th February and from my conversations with major shareholders RAB Capital and SRM Global it seems they are also confident that a private sector solution will be found. So with the prospect of nationalisation receding, the share price rose by over 40% on the day of the Treasury announcement.

The Three Solutions

There are currently three proposals that it appears will likely be put forward by the required deadline – others are probably unlikely because of the very short time that has been allowed. The three solutions are the Virgin Groups, the Olivant proposal and one developed in house by the company itself. Some details of the Virgin and Olivant proposals have been given in previous notes, although they will probably need to be revised slightly to take account of the Government proposals – in addition it seems to us that the Virgin proposal would need to be improved considerably if shareholders are going to accept it.

All three solutions are likely to involve major "rights" issues where existing shareholders have to subscribe for more shares so as to bolster the working capital and balance sheet of the company. Clearly this would be a problem for many smaller shareholders who may not have much spare cash and it has been suggested that smaller shareholders be permitted to subscribe in stages.

All three solutions would also almost certainly require to be put to a vote of shareholders, but it is probable that the directors will only put one specific solution to shareholders along with their supporting recommendation. Presumably the Government will tell them which one to pick, although legally this is very doubtful as it means the Government is acting as a "shadow director". One hates to think about what happens if the directors and the Government choose a proposal, such as the Virgin one, which is then voted down by shareholders. We trust the directors will consult the major stakeholders and shareholders before deciding to recommend any of the proposals.

New Director Appointed

On the 18th January, the company announced the appointment of another non-executive director – Paul Thompson. He was previously chief executive of Britannic/Resolution as well as having worked for Merrill Lynch and BZW. It has been pointed out that he might be a potential chief executive to lead any in-house company solution.

Why We Don't Issue More Updates and Some Comments on Media Reporting

You may be wondering why we did not rush out our comments on the above news as soon as possible. There are two simple reasons. Firstly we don't like to send out more than one "update" per week in case recipients feel they are being bombarded with too much information too frequently. Secondly it sometimes takes us time to digest and interpret the news, and it certainly takes us substantial effort to write these notes and issue them to the several thousand people who are now on our email contact list.

We certainly don't wish to follow the lead of the media who consistently publish erroneous facts and misleading interpretations – as certainly happened on reporting of the EGM for example.

The Treasury announcement again drew a chorus of disapproval from many press and TV commentators, with the Financial Times editorial calling it "half baked". Others still called for nationalisation, perhaps in the hope that this would drag out the story for many more months. Are they hoping that the resulting expensive and extended law suits would give them more front page stories? Or perhaps they are disappointed that the Government has neatly escaped the attacks of its critics while protecting the interests of the company and its stakeholders?

The Prime Minister probably got it right when he emphasised the need to provide financial stability and restore confidence in the finance sector. Any other solution could be even more damaging to the reputation of the UK financial industry than the Northern Rock debacle has already been. It is a sensible way out, that minimises the risk to the taxpayer and should hopefully enable the company to recover in due course to the benefit of everyone.

But some people seem to think that shareholders, particularly relatively new ones such as those "hedge funds" which they identify as the root of all evil in the stock market, should be punished to teach us all a lesson – although what the moral of that lesson might be I am certainly not clear.

If you have the time to write to the newspapers to refute any of their more outlandish allegations, then please do so. We have been working a lot on communicating more accurate information to the media, but they seem to prefer "melodrama" to calm reporting with the result that they often grossly distort the situation as we see it.

Other Activities

We have continued to write to shareholders and of course to regularly communicate with our existing contacts – this is important, because as pointed out above, there will almost certainly be a vote of shareholders in due course. We have received donations from about 500 people so far, a small minority of those we are communicating with, so if you have not yet donated please consider doing so by going to this page of our web site: www.uksa.org.uk/Northern_Rock_Appeal_Letter.pdf .

Note that UKSA has still spent considerably more on this campaign than we have received in donations, and with our own resources being severely limited this is inhibiting our campaign activity considerably.

Quotations Required

Have you found these newsletters useful? Are you happy with the activities of this group and the UK Shareholders Association? If so perhaps you could send us some comments that we could put into print. We are looking for some quotations that we could use to promote membership of the Northern Rock Shareholders Action Group and the Association in general so please send any comments to the email address below.

Yours sincerely

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