To Northern Rock Shareholders

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Northern Rock Shareholders Action Group – Update No. 22

Government Ensures the "Hair Shirt" Approach to the Recovery of Northern Rock

Since our last report, it has become clearer what the result of the Government's approach to Northern Rock will be. In essence they expect the company to don a "hair shirt" and adopt a business plan that will handicap the company severely going forward. Jobs will be lost and the business will be considerably shrunk so as to enable it to repay the bonds supported by Government guarantees in only three years.

In our view this is equivalent to setting the prisoner free, but not removing his ball and chain so that he continues to be handicapped. What is the point of this approach to planning for a business recovery? We think it is simply an unreasonable and illogical attack on the current and future shareholders in an attempt to punish the past shareholders for imagined failures, and to ensure that neither they nor any new investors will profit going forward.

One result has been that Olivant has dropped out of the race to submit proposals for the future of Northern Rock, and the business plans of the two remaining contenders have been adjusted accordingly. But the more damaging consequences are the reduction in jobs in the North East and the impact on other stakeholders such as suppliers to the company and the Northern Rock Foundation (who rely on the profits of the company).

Other banks and building societies must be overjoyed to hear that the competition from this low cost provider of mortgages will be substantially reduced for the next few years. Not only have other deposit takers seen over £10bn taken out of Northern Rock and invested elsewhere, but now they will not need to fear competition for new mortgage business. Why has the Government decided on such an anti-competitive plan?

The Details of What is Proposed

To remind you, the Government plan is for Northern Rock to issue about £25 billion of bonds that will be sold to financial institutions worldwide. The cash raised by the company in this way will be used to repay the existing loans from the Bank of England. The Government will guarantee these bonds to ensure they can be sold. It now seems that the Government is only willing to provide such a guarantee for 3 years, so implying that the bonds must be repaid by the company after 3 years, which is a relatively short period of time.

What are the implications of this? It means that any business plan the company adopts must generate £25 billion in cash over three years. There are a number of ways to do this. Clearly one approach that might help is to write minimal new mortgages as that will reduce the cash going out of the company.

Secondly, existing mortgage holders will need to be encouraged to redeem their mortgages by charging penal rates of interest or by providing other “incentives” for them to take their business elsewhere. By so doing the assets of the company, that are currently tied up in such mortgages will be released and made available to repay the bonds. It has been suggested that the company’s in-house plan foresees a halving of Northern Rock’s mortgage book. This of course is not going to help the reputation of Northern Rock in their customer base though.

But if you are not writing many new mortgages, and the existing customer base is shrinking, you need far fewer staff. So the Financial Times suggested that the number might reduce from the existing 6,500 to more like 3,500, although like a lot of press comment this might be pure speculation. But Paul Thompson, the proposed leader of the company’s plan, has actually said that his plan would take the company back to the size that it was at the end of 2003.

Is the Virgin Group plan significantly different, bearing in mind their previous commitment to protect jobs? Not so far as we know. They have now backtracked on their earlier promise and Jayne-Anne Gadhia of Virgin Money has said “*We can’t continue to promise that there will be no redundancies but we would aim very much to minimise any reductions*.”

The only slight offsetting on the job front is the possible expansion of retail deposits, which Mr Thompson emphasised needed to be expanded to achieve a better balance of funding within the company.

The other onerous terms attached to this Government plan are the fact that the company will be expected to pay a fee to cover the value of the guarantee being provided, plus the Government expects to be given a warrant or option in the shares of the company so they can participate in the upside of any future recovery.

In total these terms are supposed to ensure that the plan will gain approval from the European competition authorities in Brussels as it will clearly not be providing undue support to the company and not distorting competition. However in our view it is the exact opposite in that it ensures that Northern Rock will not have the resources or capabilities to compete and will be at risk from further defaults if, for example, the housing market was to crash.

We urge the Government to take a more flexible approach so as to ensure that the company can prosper and have made representations to them on this issue. After all the Government is now a stakeholder in this business and to hobble it in this way simply makes no sense. A longer repayment term on the bonds would be one starting point.

Other News

The Official of National Statistics is to add the total debt and guarantees given to Northern Rock and its depositors to the public sector debt on the basis that they now feel that the Government has so much control over Northern Rock that it should be classified as a public sector company. This is likely to blow a hole in the self-imposed “sustainable investment” rule and undermine Gordon Brown’s reputation for prudence, much to the glee of Conservative politicians.

Both RAB Capital and SRM Global have continued to purchase shares in recent days. As major investors they have continued to support the in-house company proposal, and to oppose the Virgin Group offer. Legal and General, Schroders and several other investors have also been reported as supporting the in-house proposal.

With those investors holding about 25% of the company, and private investors who are also generally opposed to the Virgin offer holding perhaps another 25% it seems unlikely that the Virgin Group offer will succeed. Let us hope the Government does not try to force any unpopular solution onto us.

Reminder: Why we Oppose the Virgin Group Proposal

It's probably worth reminding shareholders why we oppose the Virgin proposal. The reasons are:

1. The financial structure of the proposal is too generous to Virgin and does not represent fair value for existing shareholders. Virgin will end up owning 55% of this company, with very substantial assets, and are not paying enough for it.

2. It involves a very substantial rights issue – in other words a requirement for you to subscribe for new shares. Although the other possible proposals also involve a rights issue to existing shareholders, you end up owning a relatively smaller proportion with the Virgin offer.

3. Investors generally do not like to be shareholders in companies where there is one single shareholder who has control – and in this case Virgin Group would do so as they would own 55%. It of course would make the company very vulnerable to a subsequent takeover bid by Branson, which could be made before the company has properly recovered and at a relatively low price.

4. The management team proposed by Virgin is questionable and comprises a very elderly Executive Chairman (Sir Brian Pitman) and Jayne-Anne Gadhia who has no experience of running a large bank.

5. The value attached to the Virgin Money business which is proposed be merged into Northern Rock is unrealistically high. Also the fees proposed for use of the "Virgin" name are excessive (Branson proposes to rename the company "Virgin Bank").

On the last point, it's worth quoting from a letter I wrote to the Financial Times this week following an article in the Lex column that suggested Northern Rock shareholders were "in denial" and that nobody would deposit money in a bank called "Northern Rock":

"Your Lex columnist seems to have made the typical assumptions of a London based writer about the attractiveness of the Northern Rock name to its existing and prospective customers. One of the key reasons why the 100,000 plus smaller shareholders in Northern Rock, most of whom are based in the North of England, do not like the Virgin proposals is because they see no need to change the name. Neither do they like Mr Branson's flashy, publicity-seeking, approach to life or the proposal to rename the company as "Virgin Bank" which would appear to have the wrong connotations for any savings/mortgage bank. Most people would want to partner with a bank that is long in the tooth rather than one that is a virgin. There is surely also a simple "cultural divide" that I have noticed among Northern Rock shareholders between southerners who appreciate Branson's flamboyant approach to business and those in the North who have a more reserved and stoic attitude to life, and who are in no rush for needless change.

Most Northern Rock customers, and I am one such long standing depositor, appreciate the past efficient service provided by Northern Rock and we think it is a positive benefit to retain the name and personality of the business. Rebranding does not make much sense, but if it is going to be changed it should be to a name which has the same solid respectability. "

Northern Rock Deposits, Rates Offered and Investors Regaining Confidence

However the Financial Times did praise the latest Northern Rock offering in their "Deal of the Week" section. This is the 6.9% fixed rate bond with instant access that they have been advertising. It is unusual to get such a high rate of interest (fixed until January next year) and yet still have immediate, penalty-free withdrawals.

Robin Ashby of the Northern Rock Small Shareholders Group has been encouraging people to show their support for the company by increasing their deposits with them. All I can say is that with the attractive rates on offer on my "Silver Saver" Account, including the 0.5% loyalty bonus, and the certainty of the Government guarantee behind it, I personally decided to take his advice.

Other investors seem to have done the same as Paul Thompson has pointed out that £500m was taken in from retail deposits in the last two weeks. Confidence in a bank is all important and it seems that now people are coming to realise that Northern Rock will almost certainly stay in business, one way or another, that there is no longer any resistance to taking advantage of the good investment rates they now offer.

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