

# Provisional **Northern Rock** Restructuring Plan: Executive Summary

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### **A. Background to Temporary Public Ownership and the Restructuring Plan**

The core business of Northern Rock plc (the “Bank”) is secured residential mortgage lending.

During the first half of 2007, Northern Rock’s operational performance was in line with previously stated strategic targets, with asset growth of 12.4% over the six months to 30 June 2007. However, financial performance was impacted by margin pressure experienced in the first half of 2007, due in large part to the prevailing interest rate environment as well as the Bank’s timing of transacting hedges for fixed rate mortgages. This resulted in a downward revision to profit guidance in June 2007.

Northern Rock raised £12.1 billion in aggregate in the first half of 2007 to support growth through the four funding channels of wholesale funding, securitisation, covered bond issues and retail deposits. The Bank also sold a tranche of commercial secured loans in June 2007 with further tranches sold in the second half of the year. These transactions provided additional funding for secured residential lending amounting to £1.46 billion. As at 30 June 2007

around 75% of Northern Rock’s total funding was sourced from the non-retail money markets with £53.8 billion of total non-retail funding balances of £80.5 billion, i.e. two thirds, raised from securitisations and covered bonds.

Concerns about credit exposure in financial markets began to surface in the summer of 2007 and credit spreads (the cost of credit) increased. The announcement by a major US investment bank of difficulties in one of its investment conduits and subsequent similar announcements by other banks led to a serious disruption in the medium term funding markets on 9 August 2007. This quickly led to severe restrictions in the liquidity of the short term wholesale markets. In the week commencing 10 September 2007 it was necessary to arrange a facility to provide liquidity for Northern Rock in the event that medium term and securitisation markets failed to reopen. This facility was provided by the Bank of England at a premium rate of interest.

In the days that followed the grant of the Bank of England facility, there were significant withdrawals by Northern Rock’s retail depositors reflecting customers’ concerns as to the security of their savings. The substantial amount of retail deposits withdrawn following the grant of the

loan facility, together with the impact of maturing wholesale funding, contributed to Northern Rock having to draw on the Bank of England facility.

On 17 September 2007, the Chancellor of the Exchequer announced that, should it be necessary, arrangements would be put in place to guarantee all existing deposits in Northern Rock during the current instability in the financial markets, which significantly slowed the level of customer withdrawals. The guarantee arrangements were clarified and extended by HM Treasury on 20 and 21 September, 9 October and 18 December 2007 to include all unsecured retail products, all uncollateralised derivative transactions and all obligations of the Company to make payments on the repurchase of mortgages under the documentation for the Granite securitisation programme. In order to minimise any unfair commercial advantage to the company, Northern Rock has agreed to pay a fee to HM Treasury for the guarantee arrangements. Consent was obtained from the European Commission for the provision of support for the six months from 17 September, in accordance with European law.

Following a strategic review with its advisers Northern Rock, having consulted with the Tripartite Authorities (HM Treasury, the Bank of England and Financial Services Authority) acting in their respective capacities, explored a range of options for the business; these included proposals put forward by both management and third parties. On 17 February 2008, the Chancellor of the Exchequer announced that this process had failed to reach a solution that adequately safeguarded taxpayers' interests and that the Government had decided to take Northern Rock into a period of Temporary Public Ownership. A further submission to the European Commission in relation to the longer term restructuring proposals was made 17 March 2008 and the existing arrangements may be maintained while this submission is considered.

The Tripartite Authorities have set out their objectives for Northern Rock during the period of Temporary Public Ownership: to protect taxpayers, to maintain wider financial stability and to protect consumers. Northern Rock's Provisional Restructuring Plan (the "Plan") has been developed to achieve these objectives in a way that complies with State aid

requirements. It sets out the basis for the removal of financial support provided by HM Treasury and the Bank of England through the creation of a smaller, more focused and financially viable mortgage and savings bank that will be returned in due course to the private sector.

Those elements of the Plan which are likely to impact on Northern Rock's workforce remain subject to consultation with representatives of Unite and other employee representatives before any final decisions are taken.

## **B.** Northern Rock's objectives and strategic priorities

Northern Rock's prime objectives are the repayment of the Bank of England debt, the release of HM Treasury guarantee arrangements and a successful return to the private sector.

The Bank will pursue four strategic priorities in order to achieve these objectives by creating a smaller, more financially viable mortgage and savings bank. These are to:

- **Repay the facilities provided by the Bank of England**, principally by contracting the business to become smaller and more sustainable – reducing the balance sheet from around £107 billion in 2007 to about £50 billion by the end of 2011, and withdrawing from several non-core businesses
- **Align the organisation and operation of Northern Rock** under a new executive management team with a proposed downsizing and reshaping of the organisation, while supporting employees through this process
- **Build a stand-alone funding and capital position** that will facilitate the earliest possible release of the HM Treasury guarantee arrangements and a return to the private sector, with retail deposits representing a greater proportion of total funding (although at a lower absolute level than before the 2007 crisis)

- **Strengthen the risk and control environment** throughout the Bank by means of improved risk organisation, capabilities and processes

The overall effect of the Plan, under a base case scenario, would be an improvement in profit before tax from a substantial loss in 2008 to break-even in 2011 followed by progressive profit improvement. In 2008 the business is expected to be significantly loss-making, as a consequence of both the anticipated one-off restructuring costs, which are likely to be substantial, and higher funding costs. In the years following this, and reflecting a lower cost base, the Plan anticipates that Northern Rock will achieve sustainable profitability and a financial structure sufficient to obtain a stand-alone credit rating of at least A- and a return to the private sector.

Section C provides details of Northern Rock's strategic priorities and the actions the Bank proposes to deliver these.

The Plan also recognises that Northern Rock cannot take advantage of the support it receives from Government during the period of Temporary Public Ownership to compete on a basis that is unfair or that introduces competitive distortions into the markets in which it operates. The basis on which the Bank intends to compete over this period will therefore be constrained by adherence to a set of self-imposed competitive restrictions. These are set out in Section D.

## C. Achieving Northern Rock's strategic priorities

The Plan, which has been developed on a six year horizon, sets out the Board's present assessment of the actions most likely to achieve Northern Rock's four strategic priorities. As the market environment evolves, the management team and the Board will periodically assess progress and adapt the Plan as necessary, subject to the approval of HM Treasury under the governing Shareholder Framework Document. Any adaptations to the Plan which may impact on Northern Rock's workforce will be the subject of consultation with representatives of Unite and other employee representatives.

### 1. Repay facilities provided by the Bank of England and contract to a smaller, sustainable business

Northern Rock's planned commercial strategy has as its priority the repayment of the Bank of England debt through the contraction of the balance sheet from £107 billion in 2007 to around £50 billion by 2011. Under the Plan, repayment will come primarily from accelerating the pace of consumer mortgage repayment (redemptions) and proposed withdrawal from non-core lending activities. In parallel, modest development of the Bank's retail savings base will create a more balanced funding platform for future growth.

- **Accelerate mortgage redemptions**

In order to reduce the size of its balance sheet to a sustainable level, Northern Rock will work to achieve a considerably higher level of mortgage redemptions than has historically been the Bank's practice. Management expects that, by ceasing the Bank's proactive retention programme and encouraging and helping existing customers to transfer their mortgages to other lenders shortly after the customer's fixed or discounted period expires, redemption levels of some 60% can be achieved.

The redemption programme will involve contacting those customers with mortgage products approaching the end of their fixed or discounted period and helping them find a new mortgage product elsewhere. Customers will be directed back to a panel of selected mortgage intermediaries who will assist them in finding a new mortgage with another lender. The company will also explore arrangements to provide mortgages directly to some customers on behalf of other lenders. This would enable Northern Rock to improve its service to customers and help achieve the desired level of redemptions.

It is proposed that, generally, customers who remain with Northern Rock once fixed or discounted periods come to an end will move onto the standard variable rate. The redemption programme will provide customers with sufficient notice of their product maturity and new payment details, at all times observing regulatory requirements to treat customers fairly.

■ **Develop Northern Rock's savings business**

It is critical for the future viability of the Bank to achieve a more balanced mix between retail and non-retail sources of funding. In order to do this, Northern Rock plans to rebuild its retail savings business, as other funding sources contract, to create a sustainable mix. The Bank will achieve this with gradual growth in its retail funding base from its present market share of around 1.0% – although it will remain substantially below the Bank's pre-crisis level of 1.9% of UK retail deposits stock. This approach aims to increase the proportion of retail funding to around 50% of the Bank's total funding by 2012 (compared to 15-20% in 2008).

Northern Rock will aim to recapture many of its recently lost customers, develop a better mix of high value and low balance depositors, and encourage a higher percentage of accounts under £35,000. Northern Rock plans to offer a broad product range and utilise all of its existing channels (postal, branch, online and telephone) to attract savings. In particular, Northern Rock's branch network has an important role to play in attracting, servicing and retaining savings accounts. The Bank's branch network will be maintained at its present size throughout the Plan period, although, having regard to the requirement to moderate its competitive impact, the network will not be extended.

The Irish and Guernsey savings businesses will be retained, providing important funding diversity. Northern Rock's share of the Irish market has always been small and will remain below 0.8% until 2011.

Under the Plan, it is proposed that normal non-retail funding activities will very gradually recommence from 2008 to 2012 as Northern Rock's financial profile improves, investor appetite returns and available terms become more attractive.

■ **Retain a reduced core lending business**

In order to facilitate its return to the private sector as a mortgage and savings bank, Northern Rock plans to retain a footprint in the new mortgage

market averaging £5 billion per annum of gross new lending from 2008 to 2011 (compared to a total of around £30 billion in 2007). New mortgage lending will also assist the management of overall credit quality and the maintenance of Northern Rock's financing programmes (such as Granite) in a prudent manner.

Lending will be offered predominantly to high credit quality customers with standard residential mortgage products. The "Together" product (100%+ loan-to-value lending) has been discontinued for new customers. Credit quality will be managed with more selective credit quality standards and lower loan-to-value ratios for all new business taken on.

New lending will be originated mostly through intermediaries, maintaining this distribution channel and especially Northern Rock's panel representation with key intermediary organisations. The intermediary channel is strategically important to Northern Rock: historically, it has represented approximately 90% of lending volumes. The planned intermediary channel lending envisaged under the Plan represents approximately 15% of Northern Rock's historic volumes through this channel.

■ **Re-establish the Northern Rock brand and revitalise marketing**

The "Northern Rock" branding will be retained. Although retail customer confidence has eroded, recent research on behalf of the Bank indicates continuing loyalty to the brand (in particular in the north-east of England and among IFAs). A continuing research programme will confirm the validity of this strategy and assist the development of appropriate marketing activity to support the Plan.

■ **Discontinue non-core business lines**

Northern Rock has already announced the run-off and closure of its Danish savings operations in 2008. In addition the Bank will discontinue unsecured lending (2007: £4.0 billion closing balances) and allow these loan books to run down over the period of the Plan.

Subject to consultation with representatives of Unite and other employee representatives over the

coming weeks, Northern Rock proposes to discontinue commercial lending (2007: £1.3 billion closing balances including commercial buy-to-let) and to allow this loan book to run down over the period to 2011.

Earlier sale or other options to liquidate these portfolios will be considered alongside any proposals put forward by Unite or the other employee representatives.

## 2. Reconfigure Northern Rock's organisation and operations to reflect the new commercial strategy

In order to achieve its objectives, Northern Rock's organisation and operations must change as follows:

### ■ **Strengthen leadership and capabilities**

The Plan envisages a major restructuring and carries with it a significant number of financial and operational risks. Its successful delivery, particularly in the context of a challenging market environment, requires additional experience and strengthened leadership of the Bank.

In addition, Northern Rock will strengthen its risk management and controls and take additional steps to manage risks entailed in the downsizing strategy.

The leadership of Northern Rock has been strengthened with the appointment of two new executive Board members: Ron Sandler, Executive Chairman, and Ann Godbehere, Chief Financial Officer. Andy Kuipers has continued as Chief Executive Officer working with the new Executive Chairman and Chief Financial Officer.

The Government, in consultation with Ron Sandler, has appointed three new non-executive directors: Stephen Hester (Deputy Chairman and Senior Independent Director), Chief Executive of British Land and former COO of Abbey National plc; Philip Remnant, chairman of the Shareholder Executive and a former banker; and Tom Scholar, a senior HM Treasury civil servant. Several Board directors have retired during the transition

to Temporary Public Ownership. Together these changes have significantly adjusted the composition of the Board, bringing new leadership and additional valuable experience and expertise.

Within Northern Rock, the executive team will take steps to further strengthen the organisation's capabilities, in particular in risk, internal audit, finance, treasury and human resources.

### ■ **Restructure the organisation and reduce operating costs**

Under the Plan, Northern Rock will become a more focused and smaller business in order to facilitate a return to the private sector as rapidly as possible. The achievement of a viable and efficient business in the future will require a lower cost base and reconfigured operations.

The Plan targets a reduction in underlying operating costs of about 20%. It envisages about a one-third reduction in staff levels over the next three years based on projected business volumes with the majority of the reduction occurring in the first year. The timing and nature of the proposed downsizing, including any redundancy arrangements, will be subject to consultation with representatives of Unite and other employee representatives.

Northern Rock is committed to open communication with staff and to providing them with substantial support during the restructuring. The Bank will continue to work closely with Unite, One NorthEast and other agencies and stakeholders to minimise the impact of the proposed downsizing on staff and local communities; this includes providing outplacement services to help staff obtain alternative employment in the region.

### ■ **Review performance management**

The Plan includes a proposed review of Northern Rock's performance management practices and changes to incentive programmes. A staff incentive scheme will be introduced linked to achievement of the Tripartite Authorities' objectives under Temporary Public Ownership.

### 3. Build a stand-alone funding and capital position

Under the Plan, Northern Rock's financial strategy will focus on rapid repayment of Bank of England funding and release of HM Treasury's guarantee arrangements while developing a sustainable stand-alone funding and capital position with appropriate controls and risk management.

#### ■ **Repay the Bank of England debt by 2010**

The priority for Northern Rock's financial strategy is the rapid repayment of the Bank of England's facilities. While the timing will depend to a degree on developments in the UK housing and mortgage markets, the Plan envisages that in the base case, these facilities will be repaid before the end of 2010. A back-up liquidity facility may remain for a longer period until sufficient alternative liquidity arrangements are in place.

#### ■ **Complete the release of HM Treasury guarantee arrangements by 2011**

The intention of the Plan is that HM Treasury's guarantee arrangements will be released as the Bank's financial and strategic positions progressively improve. While release may be achieved earlier, it is prudent, given regulatory capital requirements, to expect that this will not be completed before the end of 2011. Given the limited practical experience of the consequences of releasing state guarantees of Bank deposits and wholesale liabilities, the viability of the Plan's proposals for release of the guarantee arrangements will be kept under review in the light of customer feedback, market circumstances and the requirements of the FSA, as regulator, for adequate capitalisation, liquidity and free assets.

#### ■ **Establish a stand-alone funding strategy with balanced retail/non-retail funding and managed contraction of the "Granite" funding structure**

The Bank aims to achieve a long-term credit rating of at least A- on a stand-alone basis following repayment of the Bank of England loan and release of guarantees. This will be based on the achievement of a significantly improved financial profile: a halving in balance sheet size; a greater proportion of retail

deposits (~50% of funding); a return to profitability and the end of support from HM Treasury and the Bank of England.

The Granite securitisation vehicle, a funding arrangement created and operated by Northern Rock, has been an important source of funding for Northern Rock at an attractive overall cost. The modest amount of new mortgage lending will assist the orderly operation of Granite over the Plan period. Substitution of mortgages into Granite will be substantially reduced from 2009 onwards.

#### ■ **Ensure adequate capital is held under all scenarios**

The Plan anticipates that Northern Rock will comply with FSA requirements regarding capital adequacy and liquidity at all times.

### 4. Strengthen the risk and control environment

The Board and the management of Northern Rock have commenced a substantial review and strengthening of risk management and controls within the Bank both at the enterprise and operational level across all major risk categories.

- The risk and control review has commenced with a broad scope.
- The review addresses enterprise risk management as well as an in-depth review of major business risk categories – market, credit, operational and regulatory.
- The review will develop a programme to strengthen Northern Rock's risk and control environment covering governance, organisational issues, policies, processes and reporting.
- The review commenced during March 2008 and is expected to move into implementation during June/July 2008 following Board and management approvals.

In addition, the Board and management have assessed the sensitivity of the proposals in the Plan by stress-testing it under different scenarios. They will take additional steps to manage the execution risks involved in its implementation.

- The stress-testing has included consideration of key execution challenges to the Plan as well as the impact of hypothetical market risks (for example, a mild downturn or a severe recession).
- Under all scenarios the Bank remains compliant with the current FSA capital requirements set for the Bank.
- The Board is taking measures to manage the risks to timely execution of the Plan while managing business risks and ensuring regulatory compliance.
- Regular stress-testing is planned to be performed in the future.
- The timing and method of releasing the HM Treasury guarantees will always be subject to Northern Rock's obligation to remain compliant with FSA capital requirements.

competitive differentiation through service and innovation; (e) treats all customers fairly; (f) regularly monitors and reviews adherence to the framework.

Specific commitments within the framework include the provisions that Northern Rock will limit its share of retail deposit balances to 1.5% in the UK and 0.8% in Ireland, and its share of gross new mortgage origination to no more than 2.5%, and accept constraints on its ability to compete among the top 3 rankings in major retail savings market categories. Details of the Competitive Framework are contained in Appendix I.

## D. Working within the Competitive Framework

Northern Rock recognises the responsibilities it has during State aid period and the need to avoid competitive distortions in the markets in which it operates. With this in mind, the Bank has committed itself to a "Competitive Framework" to provide stakeholders and market participants with confidence that it will not use its support from HM Treasury to compete on an unfair basis during this period.

The Competitive Framework comprises a public set of principles and specific commitments, capable of external monitoring, which are designed to minimise risk of competitive distortion while at the same time allowing the Bank the flexibility it needs to compete tactically and respond to customer demand and competitor activities as necessary. Northern Rock has developed a monitoring regime to ensure adherence to the framework.

The principles of the framework provide that while in receipt of State aid Northern Rock:

- (a) does not promote the Bank's offering on the basis of Government guarantee arrangements;
- (b) does not sustain a prolonged market leadership in any product category;
- (c) maintains market shares at well below historic levels;
- (d) seeks to achieve greater

## E. Key figures and milestones under the Plan

<b>Balance sheet</b>	<b>2006 Actuals</b>	<b>2007 Actuals</b>	<b>2009 Plan</b>	<b>2011 Plan</b>
Total assets, before fair value adjustment, £bn	101	107	61	49
Retail funding, £bn	23	10	15	20
Retail as percentage of all funding, %	24	10	26	43
Government funding, £bn	0	27*	1	0
Securitised funding, £bn	40	43	27	14
<b>UK market share of stock, %</b>	<b>2006</b>	<b>2007</b>	<b>2009</b>	<b>2011</b>
Mortgage	7.1	7.5	3.7	2.4
Retail	1.8	0.8	1.0	1.2
<b>Debt repayment &amp; guarantee targets</b>				<b>Target Date</b>
25% of facilities provided by Bank of England repaid				2008
75% of facilities provided by Bank of England repaid				2009
Facilities provided by Bank of England fully repaid				2010
Release of all HMT guarantee arrangements, subject to FSA requirements				2011
* Excludes open market repo arrangement				

# Appendix: Northern Rock

## Competitive Framework

### Overview

Northern Rock is determined to return to private ownership as rapidly as possible, as a viable, competitive bank, requiring no support from Government.

We are aware that during the period of temporary public ownership, Government support could enable us to compete, or be seen to compete, on an unfair basis.

We are determined to ensure that we will not take unfair advantage of Government support during this interim period as it is not in our long term interests to do so.

We are committing to this framework of principles and commitments while in receipt of State aid. These will be kept under review and remain subject to the requirements of the European Commission.

### Our Principles

- We will not promote our Government guarantee arrangements in any market.
- We will not sustain a prolonged presence as a market leader in the marketplace or in any product category.
- We will maintain market shares below historical levels while in receipt of State aid.
- We will strive to differentiate ourselves on the basis of service and innovation.
- We will at all times treat our customers fairly.
- We will regularly review our competitive offering and performance to ensure adherence to the framework.

### Our Commitments

- We will not explicitly refer to Government ownership in marketing literature.
- We will not allow our share of retail deposit balances to exceed 1.5% in the UK and 0.8% in Ireland (well below our historic levels of 1.9% in the UK and 1.3% in Ireland).
- We will limit our share of gross new mortgage origination to no more than 2.5% in any calendar year.
- We will not rank within the top 3 in any one of the defined 15 Moneyfacts retail deposit categories for the remainder of 2008.

