



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Rt Hon John McFall MP  
Chair of the Treasury Select Committee  
House of Commons  
London  
SW1A 0AA

5<sup>th</sup> August 2008

Dear John,

## Northern Rock

I am writing to inform you of the Government's plans to strengthen Northern Rock's capital position in the light of recent economic developments and the continued weakness and volatility in financial markets.

As you know, Northern Rock's business plan was published on 31<sup>st</sup> March. Since then, as reported in its half-year results today, Northern Rock has made good progress in implementing its business plan. It is successfully reducing the size of its mortgage book and has been paying down the Bank of England loan ahead of plan, with the net loan standing at £17.5bn at end June compared to £26.9bn at end December 2007. It is also attracting new retail deposits. The appointment of Gary Hoffman as the Company's new Chief Executive is a further welcome development, ensuring that Northern Rock will have strong and experienced leadership in the years ahead.

However, in common with other banks across the world, Northern Rock is facing a challenging external economic environment. Financial markets remain volatile and house prices have fallen. These conditions are having an impact on the profitability of all UK banks, and several have as a result decided to raise new capital. Since the summer of 2007, major UK banks have raised around £28bn in additional capital through issuing equity and selling assets.

You will recall that before Northern Rock was taken into temporary public ownership, all private sector bidders planned to inject additional capital into the business of between £700m and £1.25bn. HM Treasury did not put in additional capital on taking Northern Rock into temporary public ownership but confirmed to the Financial Services Authority its intention to take appropriate steps, should it prove necessary, to ensure that Northern Rock would continue to operate above the minimum regulatory capital requirements (reported to Parliament in a minute of 19 February 2008).



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Northern Rock is subject to the same pressures as banks in the UK and around the world. As they set out in their half-year results today, Northern Rock made a loss in the first six months of 2008, with the underlying loss before tax £176.3 million. The primary reasons for this underlying loss were lower net interest income, higher loan loss impairment provisions and lower non-interest income reflecting much lower levels of new business. Full details are set out in Northern Rock's half-year results.

The Company's results also show that residential arrears over 3 months have increased to 1.18% at the end of June, close to the latest published Council of Mortgage Lenders average of 1.21%. This increase in arrears and expected loan losses is partly attributable to the Company tightening the application of its arrears capitalisation policy and to the reduction in size of the mortgage book. But it has also been driven by wider economic factors affecting many other UK banks, who are also reporting increases in arrears in their half-year results.

Northern Rock has now informed the Treasury as shareholder that these pressures on profitability and on asset quality mean that like other banks it will need to strengthen its regulatory capital position in the coming months. We therefore need to act on the assurance we gave to the FSA in February.

The Government set out last year the objectives that would guide its actions in relation to Northern Rock - protecting taxpayers, protecting depositors, and supporting financial stability. Following discussion with Ron Sandler, Northern Rock's Executive Chairman, and after considering carefully the value-for-money case, I am satisfied that taking steps to strengthen Northern Rock's capital position is the best way to meet the Government's objectives. And in order to ensure compliance with EU state aid rules, we will need to obtain prior approval from the European Commission for the full amount of any additional capital which we think Northern Rock might require, for the entire period of temporary public ownership.

Subject to approval by the European Commission, therefore, the Government will strengthen the Company's regulatory capital position by converting the £400 million of preference shares held by the Treasury into ordinary shares, and converting some of the debt owed to the public sector into equity<sup>1</sup>. Conversion of the preference shares to ordinary shares was assumed in the original business plan and will strengthen Northern Rock's core Tier 1 capital. Northern Rock estimates that up to £3bn of debt may additionally need to be

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<sup>1</sup> As announced at Budget 2008, the Government will, during 2008-09, replace the Bank of England's loan to Northern Rock with direct Treasury funding, in order to comply with restrictions in the Treaty Establishing the European Community on central bank financing of government undertakings.



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converted to equity to ensure it continues to meet its capital requirements throughout the period of temporary public ownership. Given the requirements of the state aid regime, it is important for the Government to obtain prior approval for the maximum sum that might be required.

Because additional equity can be provided from within the existing debt to the public sector, no new cash will be provided to Northern Rock. In line with the announcement in the 2008 Budget of the treatment of Northern Rock in the public finances, the transfer will be scored as a capital grant. It will not increase current spending or public sector net borrowing, but, as a result of the convention adopted, it will add to public sector net debt, once the conversion has taken place. However the value of the additional equity will be reflected in the sale price for Northern Rock on return to the private sector, which will reduce public sector net debt at the point of sale.

We will be working closely with Ron Sandler and with the European Commission to finalise this package, with the aim of ensuring value for money for taxpayers and securing approval under the state aid regime. Further details will be announced to Parliament in the autumn.

In the meantime, the Government guarantee arrangements to Northern Rock's depositors remain in place, and savers' money remains safe and secure. Northern Rock continues to be regulated by the FSA and meets its regulatory capital requirements.

Further details of Northern Rock's performance are set out in the half-year results published on their website today. As promised during the passage of the Banking (Special Provisions) Act, we will make a further report to Parliament in the autumn on progress against the business plan.

I am depositing a copy of this letter in the Libraries of both Houses. In the view of the public interest in this matter, I am also publishing this letter today.

I am writing in similar terms to Edward Leigh MP.

*Yours sincerely  
Alistair Darling*

**ALISTAIR DARLING**