>opinion

A look under the Rock

Is Northern Rock's situation as dire as the financial press tells us? **Simon Woolcott** offers a fuller analysis of its half-yearly results.

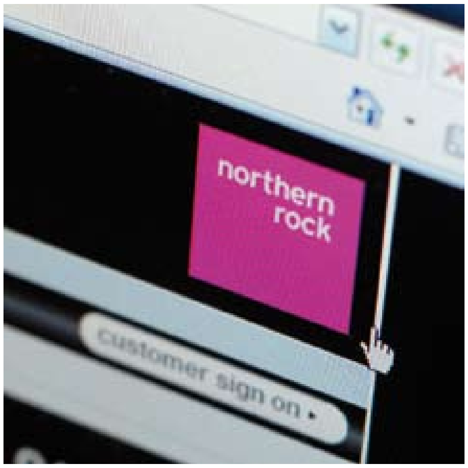
Northern Rock (NR) recently published its first financial results since nationalisation. Some of these were covered in depth by the media, but their reports told only part of the story. To understand how the bank is really doing, I have looked at all the half-year figures and the fine print.

The important message from these results is that the business is shrinking. They also show that the financial engineering that was an integral part of NR is now working against it. Mortgage redemptions and asset sales have helped to shrink the book and, while the number of redemptions where customers are getting to the end of their product period are higher than expected, the slowdown in the housing market has meant that redemptions owing to house moves are below plan.

Savings balances have grown by £3.5bn (34 per cent) over the past six months, with all the new cash being attracted into postal and online accounts. This is likely to have driven up the costs of funds, as the internet is a rate-sensitive distribution channel for retail savings.

The media have focused on the £3bn injection of share capital, but it's clear that not all of this is needed immediately. It's also clear that the losses reported have dented both the tier-one capital ratio and the total capital ratio. I don't know what the effect of the change to the Basel II basis of calculating regulatory capital will have had, but it's fair to assume that NR's risk profile has increased.

The bank's loss before tax for six months was £585m. This was £882m worse than the first half of 2007 and £122m worse than the second half of 2007. The media pundits tell us that this is all down to losses on 125 per cent loan-to-value-ratio mortgages and redundancy costs, but in fact these aren't the main reasons. A quick look at the results for the first half of 2007 compared with 2008 shows just how much the world has changed in a year and how the results to June 30, 2007 seem to come from a different era of optimism and growth. Of course, we should also accept the "new broom" syndrome – wanting to get all of the financial bad news out of the way before the benefits of improvements start to show.



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The biggest area of change is the net interest margin. This is £444m less than the first half of 2007 and £421m less than the second half – there seems to be some consistency here. The interest margin has fallen by 0.8 per cent compared with 2007. The net interest income has collapsed for a number of reasons:

- Cheaper funding has had to be replaced by more expensive funding, whether from the Bank of England or from the markets more generally.
- Some of the hedges entered into in the past are no longer efficient and the accounting rules requiring the value of financial instruments to be revised regularly are hard to apply when there is barely a market for them.
- The disposal of the equity-release portfolio (£2.3bn) in the first half of 2008 cost £14m compared with the first half of 2007. And the sale of £1.4bn of commercial mortgages to Lehman Brothers in 2007 meant a £33m loss of ongoing income.

Other income (down £115m compared with the first half of 2007) also shows the signs of strain from much reduced lending, together with losses generated from tidying up the treasury activities both funding the business and investing surplus funds. The fall in fee and commission income amounts to £67m of the total reduction of £115m.

Exceptional items amount to £166m. Of this, £37m is for redundancy costs and another £40m is for the cancellation of staff share schemes. About £45m has been spent on advisory fees in various forms (on top of the £41m spent in 2007) and £36m has been charged for writing down assets.

The last big item is loss provisions or "impairment charges on loans and advances" – up £135m on the first half of 2007 together with £47m for impairment charges on unsecured investment loans. The accounts show only the amount added to loss provisions, so we don't know the value of losses actually incurred.

Residential mortgage provisions are up by £51m compared with the first half of 2007 and now are 0.14 per cent of mortgage balances. Buy-to-let (BTL) mortgage provisions are also on the increase: up £21m (in addition to £16m in the second half of 2007). This makes BTL provisions 0.39 per cent of the balances and almost three times the level put aside on residential mortgages.

As might be expected, the unsecured loan book carries much higher provisions, having increased over six months by £117m and representing 3.6 per cent of balances. Unsecured loan balances fell by £1bn over the six months, which shows the effects of shorter-lived loans and no new lending.

So it's a complex story. The new management team has tried to clear the decks by making provisions against expected losses and for downsizing the business. The big unknown is the high cost of the financial engineering that continues to go against NR. While the bank took this to extremes in its dash for growth and market share, all of its competitors have suffered from the effects of the credit crunch on normal hedging and asset and liability management. I wish Northern Rock well.

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