The Bradford & Bingley plc Compensation Scheme

Independent Valuer – Peter J Clokey

Assessment Notice in respect of shares and subscription rights

5 July 2010

Contents

Any party dissatisfied with this Assessment Notice may require me to reconsider my determination. To do so they should submit a request for me to reconsider together with the reason for the request and any supporting evidence. This request should be made to me by Friday 27 August 2010 at PricewaterhouseCoopers LLP, 1 Embankment Place, London WC2N 6RH. I will then consider all such requests and then issue a Revised Assessment Notice which will explain whether I have upheld or varied my Assessment Notice.

1. Introduction

1.1. On 24 June 2009 I was appointed by Her Majesty's Treasury ("HMT") as independent valuer for the purposes of the Bradford & Bingley plc Compensation Scheme (the "Scheme") established under The Bradford & Bingley plc Compensation Scheme Order 2008 (as amended) (the "Compensation Scheme Order").

1.2. My role has been to determine the amount of any compensation payable by HMT under paragraphs 3 to 5 of the Schedule to the Compensation Scheme Order. This document is an Assessment Notice issued on 5 July 2010 pursuant to paragraph 10 of the Schedule to the Compensation Scheme Order. In this document I set out the reasons why I have determined that no compensation is payable by HMT to:

- Persons who held ordinary shares ("shareholders") in Bradford & Bingley plc ("Bradford & Bingley") immediately before they were transferred by The Bradford & Bingley plc Transfer of Securities and Property etc. Order 2008 (as amended) (the "Transfer Order"); and
- Persons whose rights or other entitlements to receive ordinary shares ("holders of subscription rights") in Bradford & Bingley (within the definition of "subscription rights" set out in paragraph 4(3) of the Schedule to the Compensation Scheme Order) were extinguished by virtue of article 5 of the Transfer Order.

1.3. Over the last year I have met with many parties to gather perspectives and information that might be relevant to my determination. These parties have included the current and former executives of Bradford & Bingley, the Bank of England, HMT, the Financial Services Authority (the "FSA"), the Financial Services Compensation Scheme (the "FSCS") and various advisers of relevant parties. I have also been contacted by many individuals and groups who have raised issues and concerns with me. In reaching the conclusions that I set out in this Assessment Notice I have considered carefully all of the evidence and arguments that have been made available to me. I would like to thank all those who have assisted me in my task.

2. Statutory provisions

Summary

In this section I summarise the most important statutory provisions that have been relevant to my determination of any compensation.

Transfer of Bradford & Bingley shares

2.1. Paragraph 3 of the Schedule to the Compensation Scheme Order provides that the amount of any compensation payable by HMT to a person who held ordinary shares in Bradford & Bingley immediately before they were transferred by the Transfer Order "shall be an amount equal to the value immediately before the transfer time of all shares in Bradford & Bingley held immediately before the transfer time by that person." The "transfer time" is defined in paragraph 2 of the Schedule to the Compensation Scheme Order as "8.00 a.m. on 29th September 2008".

Extinguishment of rights in relation to shares in Bradford & Bingley

2.2. Paragraph 4 of the Schedule to the Compensation Scheme Order provides that the amount of any compensation payable by HMT to a person whose rights or other entitlements to receive ordinary shares in Bradford & Bingley (within the definition of "subscription rights" set out in paragraph 4(3) of the Schedule to the Compensation Scheme Order) were extinguished by virtue of article 5 of the Transfer Order "shall be an amount equal to the value immediately before the transfer time of that person's subscription rights." The same definition of "transfer time" applies[1].

Statutory assumptions

2.3. Section 5(4) of the Banking (Special Provisions) Act 2008 (the "Act") provides that in determining the amount of any compensation payable by HMT I must assume that:

- all financial assistance provided by the Bank of England or HMT to Bradford & Bingley has been withdrawn (whether by the making of a demand for repayment or otherwise); and
- no financial assistance would in future be provided by the Bank of England or HMT to Bradford & Bingley (apart from ordinary market assistance offered by the Bank of England subject to its usual terms).

I refer to these assumptions in the rest of this document as the "Statutory Assumptions".

2.4. "Financial assistance" is given a broad meaning by sections 5(5)(a) and 15 of the Act. At the transfer time Bradford & Bingley had made use of the Bank of England's Special Liquidity Scheme (the "SLS"). In my opinion the use of this scheme would constitute the provision of financial assistance by the Bank of England. It follows that in determining the amount of any compensation payable by HMT the Statutory Assumptions require me to assume that assistance to Bradford & Bingley through the SLS has been withdrawn.

2.5. To give effect to the Statutory Assumptions, I have had to consider what sort of financial assistance constitutes "ordinary market assistance offered by the Bank of England subject to its usual terms". The term "ordinary market assistance" is defined by section 5(5)(b) of the Act as being "assistance provided as part of the Bank's standing facilities in the sterling money markets or as part of the Bank's open market operations in those markets". I have interpreted the terms "the Bank's standing facilities in the sterling money markets" and "the Bank's open market operations in those markets" to be references to two of the elements ("standing facilities" and "open market operations") of the Bank of England's published framework (the "Sterling Monetary Framework") for its operations in the sterling money markets. The SLS was not part of those elements of the Sterling Monetary Framework and, indeed, when it launched the SLS in April 2008 the Bank of England announced that the SLS "will be ring-fenced and independent of the Bank of England's regular money market operations"[2]. Accordingly, I consider that assistance provided through the SLS does not constitute "ordinary market assistance" as that term is defined in the Act. This means that the Statutory Assumptions require me to assume that assistance through the SLS would in future not be provided to Bradford & Bingley by the Bank of England.

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[1] I have adopted this definition of "transfer time" in the rest of this document
[2] Bank of England News Release – Special Liquidity Scheme, 21 April 2008

2.6. Various parties have put arguments to me to the effect that, contrary to my expressed view, assistance through the SLS does constitute “ordinary market assistance”. I have considered carefully these arguments but do not accept them because I consider that they do not properly take account of the statutory definition of the term “ordinary market assistance”.

3. Alternatives to a transfer into public ownership

Summary

I have determined that, if there had been no Transfer Order, Bradford & Bingley would have applied to Court for an administration order before the transfer time. That administration order would have been made either before the transfer time or shortly thereafter.

Financial performance

3.1. Before assessing the financial position of the Bradford & Bingley Group[3] (the "Group") immediately prior to the transfer time it is important to reflect on its financial performance. The operating profits of the Group decreased significantly in the second half of 2007 and an operating loss was recorded in the first half of 2008. This was due in part to rising impairment losses on mortgage portfolios and deterioration in operating income. Among other factors, the reduction in operating income was the result of initiatives to increase retail deposits through higher savings rates and the associated reduction in interest margin. Heavy impairment losses were also reported on the assets held as part of the Group's treasury operations between June 2007 and June 2008. The deterioration in financial performance was reflected in the share price of Bradford & Bingley.

3.2. Figure 1 sets out the financial performance of the Group over the period from January 2007 to June 2008 and highlights the deterioration in operating profitability over this period.

Figure 1: Bradford & Bingley Group summary income statement

£ in millions – half year ended	30 Jun 07[1]	31 Dec 07[2]	30 Jun 08[1]
Net interest income	271.2	276.5	246.7
Non-interest income	45.5	(20.9)	(18.1)
Operating income	**316.7**	**255.6**	**228.6**
Operating expenses	(139.8)	(140.4)	(143.4)
Operating profit pre-impairments	**176.9**	**115.2**	**85.2**
Loan impairment loss	(5.3)	(17.2)	(74.6)
Investment impairment loss	-	(94.4)	(64.8)
Operating profit/(loss)	**171.6**	**3.6**	**(54.2)**
Non-operating items	8.8	(58.0)	27.5
Profit/(loss) before tax	**180.4**	**(54.4)**	**(26.7)**
Taxation	(51.4)	18.6	9.5
Profit/(loss) after tax	**129.0**	**(35.8)**	**(17.2)**
Dividends paid	84.7	41.8	87.9
Net interest margin	1.14%	1.07%	0.98%
Impairments as % of customer loans	0.01%	0.04%	0.18%

Source: [1]Unaudited interim accounts, [2]Derived from audited financial statements by deducting the unaudited interim results

[3] Bradford & Bingley Group comprised, immediately before the transfer time, Bradford & Bingley plc and the principal undertakings of Bradford & Bingley plc, all of which were fully consolidated within and listed in the Group financial statements for the year ended 31 December 2007.

Balance sheet and capital strength

3.3. The reduction in shareholder equity, set out in Figure 2, resulted from losses suffered in the first half of 2008, the continued payment of dividends over the 18 month period to June 2008 and other movements in reserves.

Figure 2: Bradford & Bingley Group summary balance sheet

£ in millions – as at	30 Jun 07[1]	31 Dec 07[2]	30 Jun 08[1]
Residential mortgages	35,607.5	39,422.3	41,288.9
Commercial and other secured loans	4,955.2	1,022.2	907.9
Customer loans	**40,562.7**	**40,444.5**	**42,196.8**
Wholesale assets	10,923.5	9,565.0	8,036.8
Derivative financial instruments	439.3	1,121.6	1,782.1
Fixed and other assets	181.2	853.5	234.3
Total assets	**52,106.7**	**51,984.6**	**52,250.0**
Retail deposits	20,456.6	20,988.0	22,212.0
Wholesale funding (interbank and secured funding arrangements)	27,381.0	27,547.1	26,647.0
Derivative financial instruments	863.1	492.7	540.9
Other liabilities	495.3	330.7	348.3
Interest bearing capital	1,340.3	1,415.3	1,357.4
Total liabilities	**50,536.3**	**50,773.8**	**51,105.6**
Equity	1,570.4	1,210.8	1,144.4
Total equity and liabilities	**52,106.7**	**51,984.6**	**52,250.0**
Risk weighted assets	18,400.0	16,700.0	17,500.0
Tier 1 capital	1,562.0	1,436.9	1,332.4
Tier 1 capital ratio	8.5%	8.6%	7.6%

Source: [1]Unaudited interim accounts, [2]Audited financial statements

3.4. Bank capital strength is often measured by reference to its tier 1 capital ratio, which reflects forms of the bank's capital (including shareholder equity) as a percentage of its risk weighted assets. In January 2008, the Group's tier 1 capital ratio was around 8.6%. At June 2008, the Group's tier 1 capital ratio had fallen to 7.6%. This level compared well with other banks and building societies in the UK.

Reliance on secured funding arrangements

3.5. Principal sources of bank funding are retail and commercial deposits. Like many other mortgage banks, Bradford & Bingley also obtained funding through the interbank market and structured capital markets arrangements. Such funding included a secured warehouse facility with Barclays Bank plc and the issuance of debt securities known as covered bonds and residential mortgage backed securities (together the "secured funding arrangements"). The core activity of mortgage banks is to provide long-term loans to homeowners (these loans represent assets of the mortgage bank) while accepting on-demand and other short-term deposits (these deposits represent liabilities of the mortgage bank). To undertake this function a bank must expose itself to the risk that its depositors demand repayment of deposits more rapidly than the bank is able to realise funds from its assets. This is known as liquidity risk.

3.6. Domestic and international demand to invest in secured funding arrangements had enabled UK mortgage banks to access large quantities of inexpensive funding. This access allowed mortgage banks to grow more quickly than would have been possible through reliance on retail and commercial deposits alone. Mortgage banks assumed that access to these markets would continue and they developed business models on this basis. The Basel Committee on Banking Supervision[4] has explored the features of the financial crisis and state that liquidity risk management "did not receive the same scrutiny and priority as other risk areas [and

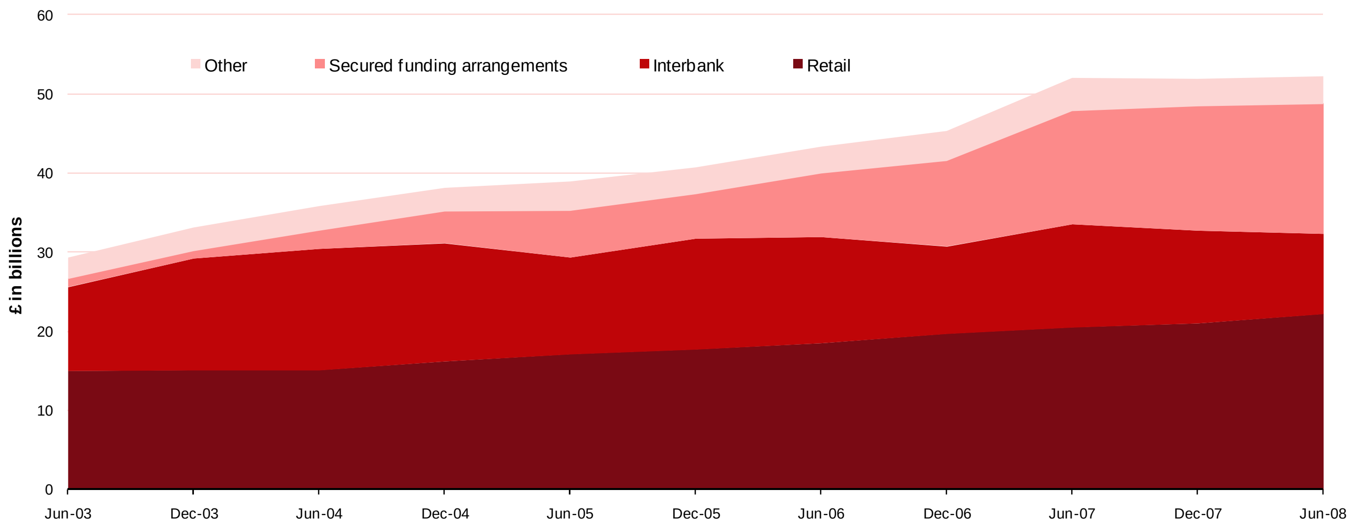
[4] Basel Committee on Banking Supervision: International framework for liquidity risk measurement, standards and monitoring: 16 April 2010

the] crisis illustrated how quickly and severely liquidity risks can crystallise and certain sources of funding evaporate." The interbank market and that for securities issued as part of secured funding arrangements became difficult for mortgage banks (and others) to access throughout 2008 and a high level of liquidity support was required from central banks.

3.7. The Bank of England became the principal source of new funding for UK mortgage banks by providing liquid assets (Treasury bills) in exchange for illiquid assets (e.g. mortgage backed securities). In a notice dated 3 February 2009 the Bank of England stated that since the launch of the SLS on 21 April 2008, Treasury bills with a face value of approximately £185 billion had been lent under the SLS to 32 banks and building societies. This notice also recorded that most of the collateral received by the Bank of England under the SLS took the form of secured funding arrangements. As at the end of June 2008 the Group had not yet drawn down any funding under the SLS.

3.8. The extent to which Bradford & Bingley relied on different forms of funding is illustrated in the chart below. In June 2003 Bradford & Bingley's secured funding arrangements as a percentage of total funding was 3.7%. Over the five year period to June 2008 this increased to 31.5%.

Figure 3: Bradford & Bingley Group funding by type



Source: Audited financial statements and unaudited interim accounts

3.9. Retail deposits that are covered by the FSCS are regarded by the Basel Committee on Banking Supervision as being relatively stable[5] in the sense that depositors are less likely to require repayment of their deposits than other short-term creditors of banks. At the end of June 2008 only 54% of the Group's residential mortgage lending was funded by retail deposits, a level that was lower than most mortgage banks and building societies in the UK. The Group had become more reliant on secured funding arrangements, accessing these for both longer- and shorter-term financing.

Third quarter 2008

3.10. Financial performance continued to deteriorate with further operating losses in July and August 2008 of £24.3 million [6].

Rights issue

3.11. These losses would have resulted in a further deterioration in the capital position of the Group if it were not

[5] Basel Committee on Banking Supervision: International Framework for liquidity risk measurement, standards and monitoring: 16 April 2010
[6] Bradford & Bingley Board reporting pack August 2008 – Issued 22 September 2008

for the issuance of new share capital through a rights issue. After initial attempts to raise fresh capital were unsuccessful, the Group was ultimately able to raise £401 million in new equity through a fully underwritten rights issue which closed on 15 August 2008. The rights issue was underwritten by Citigroup and UBS and supported by a number of the Group's largest shareholders and many of the UK's banks. As a result of the rights issue, Bradford & Bingley's tier 1 capital increased to 9.4%[7], a level that compared favourably with other UK banks and one that the Board regarded as being adequate[8].

Reliance on SLS funding

3.12. On 16 September 2008, the Group had drawn down the last of three tranches of SLS funding from the Bank of England, which in aggregate totalled £4.9 billion. Continued access to SLS funding was a vital aspect of the Group's liquidity management plans which were subject to ongoing Board review and discussion with the FSA. On 22 September 2008 the Group advised the Bank of England that a BBC Panorama programme would be screened that evening which could cause withdrawal of retail deposits, and that it would be seeking to access a further £700m from the SLS that week[9]. The Bank of England did not approve further access to SLS funding during that week despite the Group offering eligible collateral including mortgage backed securities issued by other institutions. The reason provided by the Bank of England to the Group for this course of action was that the rating agency, Fitch Ratings ("Fitch"), had notified Bradford & Bingley that it had placed its covered bonds (part of the collateral tendered to the Bank of England) on negative watch and would downgrade the covered bonds if they were not restructured[10]. Bradford & Bingley had told the Bank of England that the required restructuring would be difficult to achieve quickly and recognised that a downgrade of the covered bonds would make them ineligible for presentation as collateral for the SLS[11]. The Bank of England notified Bradford & Bingley that, if the covered bonds did become ineligible, it would require Bradford & Bingley to repay SLS funding to the extent that collateral had been provided in the form of such covered bonds[12]. Of the £7.4 billion of collateral held by the Bank of England, £2.3 billion was in the form of Bradford & Bingley covered bonds.

Ratings downgrades

3.13. Moody's Investors Service ("Moody's") had downgraded Bradford & Bingley's long-term bank deposit and senior unsecured debt ratings on 16 September 2008. Moody's announcement stated that the downgrade had been triggered by a combination of the following factors: "(i) the assessment of the expected loss within the bank's deteriorating loan portfolios indicates that the bank is weakly capitalised, and the challenge the bank faces to replenish capital through earnings or accessing its existing owners or the capital markets; and (ii) the bank's increasingly vulnerable dependence on ongoing access to the Bank of England's funding."[13] In addition, Fitch downgraded Bradford & Bingley's rating on 23 September 2008 and stated they expected "further deterioration in the bank's profitability and asset quality as the UK economy and mortgage market continue to worsen."[14]

The weekend of 27/28 September 2008

3.14. The FSA issued a First Supervisory Notice (the "FSA Notice") to Bradford & Bingley on 27 September 2008 pursuant to section 45(1)(a) and (c) of the Financial Services and Markets Act 2000 ("FSMA"). The FSA Notice varied the permission to carry on regulated activities granted to Bradford & Bingley under Part IV of the FSMA by imposing a requirement that Bradford & Bingley must not accept any deposits from new customers with effect from 7:00am (changed by a later notice to 9:00am) on Monday 29 September 2008. The FSA Notice stated that it would not take effect if Bradford & Bingley was transferred into public ownership prior to that time.

3.15. Under the heading "Reasons for Action" the FSA Notice stated:

"The FSA has concluded that the Firm is failing to satisfy the threshold conditions set out in Part 1 of Schedule 6 to the Act (the "threshold conditions") in that, in the opinion of the FSA, it has not satisfied the

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[7] Bradford & Bingley Board reporting pack August 2008 – Issued 22 September 2008
[8] Board minutes: 28 September 2008 (7:00pm)
[9] Bank of England meeting notes: 22 September 2008 (4:30pm)
[10] Bank of England meeting notes: 26 September 2008 (6:45pm)
[11] Board minutes: 27 September 2008 (5:00pm)
[12] Bank of England meeting notes: 26 September 2008 (6:45pm)
[13] Moody's downgrades Bradford & Bingley to Baa3/P-3; outlook negative: 16 September 2008
[14] Fitch Downgrades Bradford and Bingley to 'BBB-'; on Rating Watch Evolving: 23 September 2008

FSA that its resources are adequate in relation to the regulated activities that the Firm carries on. In particular having regard to all the circumstances in the opinion of the FSA the Firm's capital resources and liquidity resources are inadequate.

The FSA considers that in the interests of consumer protection and market confidence the Firm should not be permitted to accept new deposits from new customers where it has inadequate capital resources and liquidity resources and there is no realistic prospect of the situation improving within a reasonable period.

The FSA considers, on the basis of those facts and matters, that it is necessary for the action specified above to take effect at the time specified above in the interests of consumer protection and market confidence."

3.16. A number of Board meetings took place over the weekend of 27/28 September 2008. At the meetings the Board considered various papers that had been prepared in relation to core liquidity and cash out flows. These illustrated that the Group was operating at a level that was close to its core liquidity operational minimum and was anticipating further outflows over the week ahead. Although by the evening of 28 September 2008 cumulative cash outflows since lunchtime on Friday 26 September 2008 had been approximately £173 million, the Board believed that if it were possible to access further SLS funding Bradford & Bingley would have had sufficient liquidity to continue in operation. However, it appeared to the Board that access to further SLS funding was unlikely in the light of the Bank of England's concerns as it would take a minimum of four weeks to address Fitch's requirement to restructure the covered bond programme and to remove the basis for the potential downgrade. The Board considered that, as a result of the Bank of England's decision not to approve further access to SLS funding, Bradford & Bingley was likely to have unacceptably low levels of liquidity within a matter of days, possibly as early as 29 September 2008. At the same time, however, the Group Finance Director informed the Board that it should have no concerns with regard to the regulatory capital position of Bradford & Bingley.

3.17. The Board considered various other developments, including the FSA Notice and the options that HMT was considering of a transfer of Bradford & Bingley into public ownership or the brokering of a deal with one or more third parties to sell all or part of Bradford & Bingley. The Board agreed that, in the light of the liquidity position, if the Government did not proceed with either of these options before the morning of Monday 29 September 2008, it would have little choice other than to put Bradford & Bingley into administration. Bradford & Bingley's external solicitors confirmed to the Board that they were prepared to proceed with a court application for administration. The Board agreed that it would continue to monitor developments over the rest of the weekend and, in the event that no clear Government decision was communicated in a timely manner before the markets were due to open on Monday 29 September, the Board should apply to court for an administration order before the markets opened.

3.18. Bradford & Bingley's external solicitors confirmed that administration papers had been drafted and appropriate people put on notice to action the administration order if necessary. The Board agreed that a final decision in this regard would be delegated to a committee of the Board.

3.19. Bradford & Bingley was notified on the evening of 28 September 2008 that HMT had been able to bring about a part public, part private solution that would result in the sale of the deposit business and branch network to Abbey National plc ("Abbey") and the transfer of the remainder of the business into public ownership. The Transfer Order was made at 7:40am on 29 September 2008 and came into force at 8:00am. The Explanatory Memorandum to the Transfer Order records that HMT considered it desirable to make the Transfer Order for the purpose of maintaining the stability of the UK financial system.

What would have happened without the Transfer Order?

3.20. In my view, in the absence of the Transfer Order, Bradford & Bingley would not have been able to obtain an adequate source of necessary liquidity to replace the liquidity that had been consumed by cash outflows. I consider that, due to the strained conditions of the interbank market and the heavy reliance on Bank of England facilities by UK banks (including Bradford & Bingley), it would not have been possible for Bradford & Bingley to arrange funding if further access to SLS was not made available. Liquidity constraints existed across the global financial system and I consider that liquidity from UK or overseas institutions would not have been made available to Bradford & Bingley. In the absence of the Transfer Order, Bradford & Bingley would, therefore, have been unable to continue as a going concern and would have applied to Court for an administration order before the transfer time. The administration order would have been made either before the transfer time or shortly thereafter and the London Stock Exchange would have suspended trading in the ordinary shares of Bradford & Bingley before the transfer time (either following a request from Bradford & Bingley or on the FSA's own initiative).

3.21. In reaching this conclusion, I have considered and rejected various alternative options that might have been available to Bradford & Bingley, including liquidation and any private sector solution.

3.22. I do not think that liquidation (as opposed to an administration) of Bradford & Bingley would have been a realistic option. A liquidation process would usually be expected to lead to the sale of the assets of a company in the short term to realise cash. A liquidator's powers are limited and he will rarely trade on in the hope of salvaging something from the business. An administration process would better provide the speed, flexibility of purpose and legal powers necessary to deal with the complexity of Bradford & Bingley's business and its financial instruments. I discuss this in more detail in section 4 of this document.

3.23. I have also considered whether a sale of Bradford & Bingley to a larger institution would have allowed Bradford & Bingley to continue to operate by drawing on the financial resources (i.e. capital and liquidity) of a larger group. Bradford & Bingley had sought such a strategic solution from early 2008 and the Board and its advisers had explored many options.

3.24. Bradford & Bingley, its advisers Goldman Sachs and the FSA had spoken to potential acquirers over several months without securing an offer that would provide a suitable private sector solution. On 21 September 2008, Morgan Stanley had been engaged by HMT to assess, among other matters, whether there was any possibility of a private sector solution. By the middle of that week Morgan Stanley and HMT had concluded that the likelihood of a private sector solution during such a period of market disruption was highly unlikely in light of the fact that most potential acquirers were also affected by the global financial crisis and were focused on maintaining their own liquidity and capital resources. The efforts that were made to find a private sector solution demonstrate that such a course of action would not have been possible without significant support from HMT.

Impact of Statutory Assumptions on Bradford & Bingley's SLS funding

3.25. As I explain in section 2, the Statutory Assumptions require me to assume both that assistance to Bradford & Bingley through the SLS has been withdrawn and that such assistance would not be provided in the future. The withdrawal of £4.9 billion of SLS liquidity from Bradford & Bingley immediately before the transfer time would result in a breach of its sterling stock liquidity requirement agreed with the FSA. Bradford & Bingley would not have been able to replace this liquidity for the reasons explained above. It follows that the application of the Statutory Assumptions reinforces the conclusion that Bradford & Bingley would have been unable to continue as a going concern.

4. My approach to compensation

Summary

In this section I outline the approach that I have taken to assess the value of the ordinary shares and the subscription rights immediately before the transfer time. In section 3 I determined that Bradford & Bingley would have gone into administration in the absence of the Transfer Order. Therefore, I have determined that there would only be value to shareholders or holders of subscription rights if they received a distribution from the administration.

Basis of value

4.1. The amount of any compensation payable by HMT to shareholders in Bradford & Bingley is an amount equal to the value of the ordinary shares immediately before the transfer time. Similarly, compensation to holders of subscription rights is an amount equal to the value of those subscription rights immediately before the transfer time. The basis of value is not specified by statute. I consider that economic value is the appropriate basis for the reasons described below.

Economic value

4.2. I have adopted a basis that considers the economic value of ordinary shares, represented by the value immediately before the transfer time of the cash flows that a shareholder would receive. By estimating the cash flows that would arise in an administration, based on information that was available immediately before the transfer time, I am able to determine the distributions that would be likely and assess the value of those distributions to a shareholder. To the extent that there would be distributions to shareholders I must also consider whether subscription rights to shares had any value.

Other bases of value

4.3. I have considered the appropriateness of two other valuation bases: market value and fair value, and discuss why I have rejected them.

4.4. Market value may be defined as the price which might reasonably be negotiated for the assets at stake between a willing seller and a willing buyer in an open market sale on the basis that both parties have equal knowledge and that each is acting for self interest and gain. It is ordinarily assessed by reference to: a traded price in the security; offers to acquire the whole of the share capital; comparable quoted companies' trading multiples; transactions involving comparable securities; or cash flow forecasts.

4.5. It has been suggested that the closing share price on 26 September 2008 represented the market value of the ordinary shares immediately before the transfer time and that this should be important for my assessment of value. Given my conclusions on administration in section 3, including my conclusion that the ordinary shares would have been suspended from trading before the transfer time, I consider that the closing share price on 26 September 2008 does not assist me in determining the value of the shares.

4.6. I have confirmed that there were no offers at the time for all or part of the equity of Bradford & Bingley that could also have been indicators of market value. As Bradford & Bingley would have been in or about to go into administration, reference to the trading multiples of entities that may have been regarded as comparable would not be appropriate.

4.7. Fair value is often considered in a transaction involving related parties, where the value to one party differs to the value to the other party. Fair value is defined as a value that is equitable to both parties. In this case HMT's ability to provide funding and thus avoid administration creates value that is likely to be greater than the value that could have been achieved by the former shareholders of Bradford & Bingley. Given that the Statutory Assumptions require that I assess value assuming that no financial assistance would in future be provided by the Bank of England or HMT to Bradford & Bingley (apart from ordinary market assistance offered by the Bank of England subject to its usual terms), I have determined that, if I were to adopt fair value and reference the value of Bradford & Bingley to HMT, this would be inconsistent with the Statutory Assumptions.

Assessing cash flows to shareholders through administration

Overview

4.8. In order to consider economic value I must assess what distributions, if any, would have been made in due course to shareholders. I have assessed this by considering the actions that an administrator would have taken as he sought to fulfil the objective of the administration of achieving the best result in the interests of the creditors of the company as a whole.

Purpose of administration

4.9. An administrator is an officer of the Court who must exercise his functions in the interests of the creditors of the company as a whole. The primary functions of an administrator of Bradford & Bingley would be to: (i) secure control of Bradford & Bingley's assets; (ii) prepare proposals for creditors; and (iii) carry out those proposals.

The administration of Bradford & Bingley would have a single purpose as set out within paragraph 3 of Schedule B1 to the Insolvency Act 1986.

1. The administrator of a company must perform his functions with the objective of—
   a. rescuing the company as a going concern, or
   b. achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or
   c. realising property in order to make a distribution to one or more secured or preferential creditors.

2. Subject to sub-paragraph (4), the administrator of a company must perform his functions in the interests of the company's creditors as a whole.

3. The administrator must perform his functions with the objective specified in sub-paragraph (1)(a) unless he thinks either—
   a. that it is not reasonably practicable to achieve that objective, or
   b. that the objective specified in sub-paragraph (1)(b) would achieve a better result for the company's creditors as a whole.

4. The administrator may perform his functions with the objective specified in sub-paragraph (1)(c) only if—
   a. he thinks that it is not reasonably practicable to achieve either of the objectives specified in sub-paragraph (1)(a) and (b), and
   b. he does not unnecessarily harm the interests of the creditors of the company as a whole.

4.10. This single purpose provides significant flexibility of action to an administrator, representing a major advantage over liquidation in preserving the value of a business and its underlying assets. I do not believe that there was any reasonable prospect of rescue of Bradford & Bingley as a going concern by way of a sale to a third party or otherwise. In view of this, the administrator's principal objective would have been to achieve the second objective set out in the hierarchy above, which is to achieve a better result for creditors than would be likely from liquidation.

Priority of claims

4.11. Following entry into administration, the funds realised from the assets of Bradford & Bingley would be distributed in the following order of priority[15].

- Administration expenses

- Preferential debts.

- The prescribed part of the net property of Bradford & Bingley subject to a floating charge. To my knowledge, no floating charges had been granted over the property of Bradford & Bingley.

[15] Fixed charge realisations are not subject to any deductions, other than expenses incurred in presenting or realising the fixed charge assets.

- Bradford & Bingley's ordinary unsecured creditors.
- Dated subordinated noteholders.
- Post-administration interest.
- Holders of perpetual subordinated bonds and undated subordinated note holders.
- Shareholders.

Post-administration interest

4.12. No interest on the debts of Bradford & Bingley would be payable for any period after the company entered administration except where a surplus remained after the administrator had paid all debts proved in the administration ("surplus"). Any surplus remaining is then applied in paying post-administration interest on debts (other than perpetual subordinated bonds and undated subordinated notes) in respect of the periods during which they have been outstanding since Bradford & Bingley entered administration.

4.13. Post-administration interest is accrued at the greater of the applicable statutory rate (8% per annum as at the transfer time, the "statutory rate") and the rate applicable to the debt apart from the administration.

Potential distribution to shareholders

4.14. Shareholders are entitled to receive a distribution if all debt proved in the administration has been repaid together with post-administration interest.

4.15. My approach has, therefore, been to assess, first, whether and to what extent a surplus might be generated through an administration and, second, to assess whether the distribution of the surplus to creditors would be sufficient to meet the post-administration interest that would have accrued through the administration. I assess this by determining the annual effective compound rate of return on principal outstanding (the "yield") that a full payment of the surplus would allow and compare this to the statutory rate. If this yield is less than the statutory rate there would be no surplus available for distribution to holders of perpetual subordinated bonds, holders of undated subordinated notes or shareholders.

Assessment of compensation

4.16. Compensation would only be payable to shareholders if they would have received a distribution at the end of the administration. In my estimation of the outcome from the administration I make a number of assumptions about the economic environment; the performance of the mortgage portfolios whilst in administration; and the behaviour of the administrator and creditors. I have adopted assumptions which I regard to be reasonable but that are generally favourable to shareholders and collectively result in a favourable scenario. If, despite the adoption of favourable assumptions, there is no possibility of a distribution to shareholders, then I am able to conclude that the shares would have had no value immediately prior to the transfer time. If there is a possibility of a distribution, then I would consider whether this possibility in itself had value.

4.17. If a distribution were payable to shareholders following administration then I would assess the potential timeframe and apply an appropriate discount rate to reflect the time value of money and uncertainty associated with such a payment.

4.18. In the following section I consider the expected outcome of an administration and the implications for shareholders and those with subscription rights.

5. Expected outcome if Bradford & Bingley had been placed in administration

Summary

In assessing any potential distribution payable to shareholders, I have modelled the consequences of an administration scenario. I consider that an administration of Bradford & Bingley would allow the repayment of all principal outstanding on debts and would generate a surplus of approximately £5 billion. This surplus would be used in full in meeting post-administration interest. Accordingly, no residual surplus would be available for distribution to holders of perpetual subordinated bonds, holders of undated subordinated notes or to shareholders.

Approach

5.1. I have determined that an administrator would realise greater value through the selective management or, as the case may be, disposal of Bradford & Bingley's assets, rather than through a sale of the entire business.

5.2. To assess whether any distribution would be payable to shareholders, I consider:

(i) the consequences of the entry into administration on the assets and liabilities of Bradford & Bingley, including the implications of any initial actions of the administrator with regard to the assets and liabilities (for example asset disposals); and

(ii) the profits or losses that would have been generated over the course of the administration.

5.3. I have considered the strategy that would be adopted by an administrator to maximise value for the creditors and thus maximise the possibility of there being a residual surplus available to make a distribution to shareholders at the end of the administration. In developing my administration scenario I have modelled the cash flows associated with the administration to assess whether there would be a surplus available to meet the accrued post-administration interest.

5.4. I have assessed that a reasonable timeframe for an administration to provide an opportunity to maximise potential returns to shareholders would be ten years. I have assumed that regular distributions to the creditors would be made over the course of this administration period.

5.5. The most significant assets on Bradford & Bingley's balance sheet were customer loans and therefore I have considered a strategy likely to maximise returns from these loans. Part of the challenge for an administrator would be that 72% of the loan portfolio was subject to secured funding arrangements: Aire Valley Master Trust and Bowler Finance (securitisation structures established to issue residential mortgage backed securities), Bradford & Bingley's covered bond programme and the Barclays Senior Facility (described in sections 5.25 and 5.26). I have, therefore, considered the impact of administration on these secured funding arrangements.

Withdrawal of SLS funding and the opening administration balance sheet

5.6. In order to assess the balance sheet that an administrator would have had control over at the start of the administration I must first consider the impact of the withdrawal of the SLS funding, to give effect to the Statutory Assumptions. I note that administration would itself have led to the withdrawal of SLS funding giving a similar impact to that set out below.

5.7. The Act does not specify the assumptions I should make as to the terms on which the SLS funding would have been withdrawn. I therefore consider below how Bradford & Bingley's SLS funding might have been withdrawn immediately prior to the transfer time.

5.8. The Bank of England had a right to terminate the SLS funding arrangements on short notice. Upon termination, securities equivalent to those provided by the Bank of England to Bradford & Bingley and collateral equivalent to the securities provided by Bradford & Bingley to the Bank of England would have become deliverable to the other party. I consider that Bradford & Bingley would not have been able to raise the liquid assets necessary to return the Treasury bills that had been provided to it through the SLS. The failure to deliver these securities would have led to an event of default and in such circumstances the Bank of England would have determined the “default market value” (as defined in the SLS scheme rules) of the securities that Bradford & Bingley had provided as security.

5.9. I have decided to determine default market value (and therefore the payments between the parties) by reference to the price estimates that the Bank of England used to assess margin calls on securities. These are price estimates at which a small quantity of each security might be sold and are unlikely to represent the actual price that a seller would achieve if it were to sell large quantities of the securities or sell in stressed circumstances. I consider that using these prices is favourable to Bradford & Bingley in that, given the illiquid nature of the securities market at the time, the default market value that the Bank of England would have determined would almost certainly have included a further discount.

5.10. My approach has also been favourable to Bradford & Bingley in that I have proceeded on the assumption that those assets that would be retained or sold by the Bank of England to enable repayment of the SLS funding are those that attract the lowest discount to par value and therefore result in the lowest loss to Bradford & Bingley. Those assets released by the Bank of England would return to Bradford & Bingley as unencumbered assets. I discuss their treatment in paragraph 5.23 below.

5.11. On the basis of the approach described above, I have determined that the withdrawal of SLS funding would have resulted in a loss of approximately £0.8 billion. Having made this adjustment I must consider the assets and liabilities over which the administrator of Bradford & Bingley would have had control.

5.12. I have developed an administrator’s opening balance sheet (Figure 5 below) by starting with the balance sheet of Bradford & Bingley plc as at 30 September 2008 and making certain adjustments to reverse the effect of the disposal of the deposits, branch network and Bradford & Bingley International Limited (“BBI”) to Abbey that occurred immediately after the transfer into public ownership. I have then made an adjustment to remove the assets and liabilities relating to the secured funding arrangements. These are replaced by the value of the notes held by Bradford & Bingley in those programmes and the residual seller’s share or overcollateralisation. These two items appear in the summary balance sheet (Figure 5 below) in the lines “Debt securities” and “Residual interests in secured funding arrangements”. The balance sheet is shown adjusted for the withdrawal of SLS to arrive at an administrator’s opening balance sheet with equity of £0.4 billion.

5.13. While I appreciate that in practice an administration would be performed separately for each of the relevant legal entities, for the purposes of my analysis I have aggregated the relevant material assets and liabilities of the main operating subsidiaries, Mortgage Express and BBI to those of Bradford & Bingley plc.

Figure 5: Bradford & Bingley summary balance sheet – administrator’s opening balance sheet

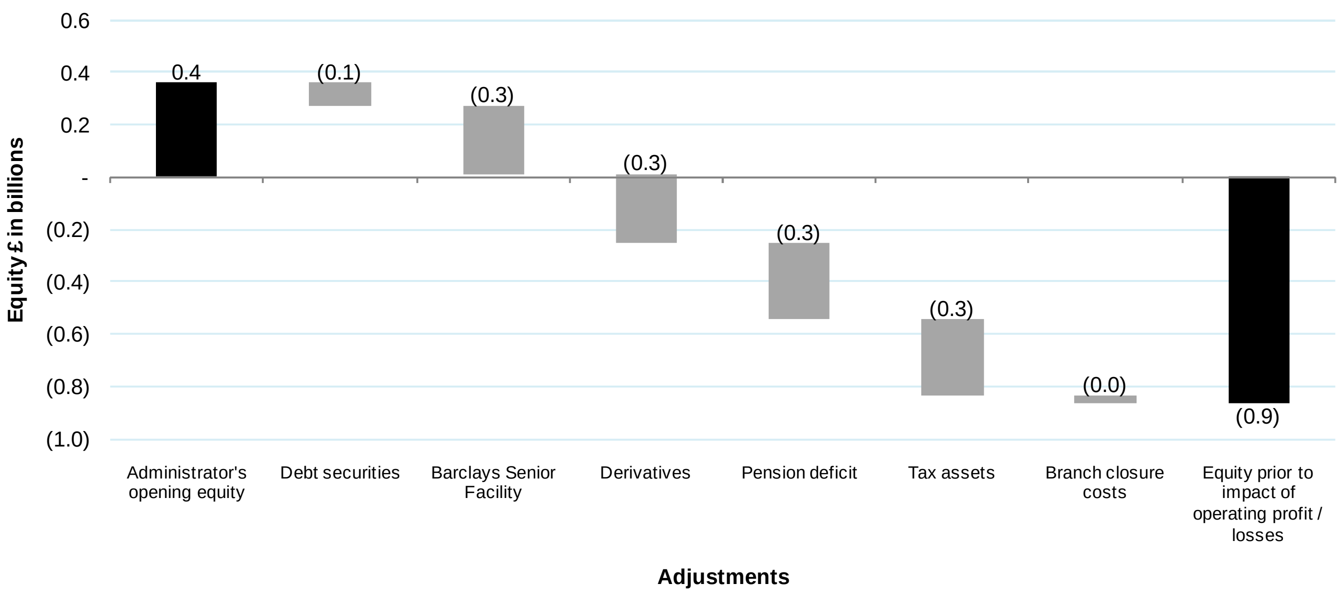
£ in billions – as at	29 Sept 08
Cash & Treasury bills	1.2
Loans to banks	1.8
Customer loans	11.7
Debt securities	8.5
Residual interests in secured funding arrangements	17.4
Derivative financial instruments	0.8
Tax assets	0.3
Other assets	0.5
Total assets	**42.2**
Retail deposits	20.3
Wholesale funding	18.1
Derivative financial instruments	0.6
Other liabilities	1.2
Interest bearing capital	1.6
Total liabilities	**41.8**
Equity	0.4
Total equity and liabilities	**42.2**

Source: Bradford & Bingley management accounts, PwC analysis

The impact of administration on the assets and liabilities of Bradford & Bingley

Summary: Based on my assumptions I have assessed that the impact of administration would be to reduce the administrator's opening equity position by approximately £1.3 billion to a position of negative equity of £0.9 billion. This would have been before the impact of profits or losses generated over the course of the administration of Bradford & Bingley. The chart below summarises the impact on Bradford & Bingley's balance sheet of the most significant factors, which are discussed in more detail in this section. The items illustrated below show the main areas where the value of the equity would be eroded at the outset of administration.

Figure 6: Impact of administration on the assets and liabilities of Bradford & Bingley



Source: PwC analysis

Treasury bills, loans to banks and other assets

Summary: I have assumed that there would be neither a positive nor a negative impact on the balance sheet of Bradford & Bingley through the realisation of liquid treasury assets and that their early realisation would allow an early distribution to creditors.

5.14. I have assumed that Treasury bills and loans to banks would all be realisable within the first year of the administration at the value at which they were held in the balance sheet of Bradford & Bingley ("book value"), as set out in Figure 5.

5.15. I have assumed that the 'other assets' as shown in Figure 5 would be disposed of at book value immediately or soon after the transfer time, with the exception of the head office of Bradford & Bingley which would be retained until the end of the administration period and then sold at book value.

Customer loans

Summary: I consider that the sale of unencumbered customer loan assets would have attracted a significant discount at that time and so an administrator would have retained these assets, selling the remaining balance at the end of the administration period. There would therefore be no initial impact on the administration balance sheet.

5.16. The main assets of the Group were customer loans. As at 29 September 2008, total loans to customers were £42.2 billion, with residential mortgages totalling £41.3 billion. Of the residential mortgages £30.5 billion were subject to secured funding arrangements, with the remaining £10.8 billion unencumbered by such funding arrangements and available to the administrator to consider options for realisation. Bradford & Bingley also held £0.9 billion of unencumbered commercial loans, giving a total level of unencumbered customer loans on the opening balance sheet of £11.7 billion.

5.17. The options available to an administrator would be to sell all or parts of the unencumbered customer loans, or to hold them and run them off over a number of years. In September 2008 a lack of liquidity in the market meant that there was limited appetite for institutions to fund acquisitions of such assets. The only significant transactions taking place were those regarded as being ‘forced sales’, requiring sellers to accept offers at significant discounts to the book value of these customer loans. In my view, an administrator would have been able to extract greater value for creditors by holding on to the assets and receiving payments of principal and interest over a longer period.

5.18. Of the £10.8 billion unencumbered residential mortgages: 44% were ‘Buy–to-Let’; 31% residential; 17% ‘Self Certified’; and 8% “lifetime mortgages”. Moreover a significant proportion (around £2.5 billion) of these loans had been originated by other lenders. Thus over two-thirds of these unencumbered residential mortgages were regarded as specialised residential lending for which there was little evidence of behaviour from past recessions. As a result, there would have been limited demand to acquire such specialised assets from a company in administration. The market for specialised mortgages was illiquid at that time with buyers requiring significant discounts to par value. I therefore consider that any offers for the customer loans of Bradford & Bingley would have been at significant discounts to their book value and that an administrator would have chosen to run-off the customer loan portfolio over the course of the administration.

5.19. As a result of the administrator’s decision to retain the unencumbered customer loans there would have been no initial impact on the balance sheet of Bradford & Bingley. I consider the implications for the profits or losses of Bradford & Bingley over the course of the administration as follows.

Debt securities

Summary: Debt securities would have come off the balance sheet of Bradford & Bingley, either through (i) the termination of repo agreements for those securities held as collateral in such agreements or (ii) their disposal. The resulting negative impact on the balance sheet of Bradford & Bingley would have been £0.1 billion.

5.20. Of the £8.5 billion debt securities on the balance sheet (Figure 5), £4.3 billion were held as collateral by third parties providing secured funding to Bradford & Bingley under arrangements known as “repurchase agreements” or “repo agreements”. The administration of Bradford & Bingley would have triggered an event of default in these arrangements and would have resulted in termination or “close out” in the manner described below.

5.21. The debt securities subject to repo agreements were held on the balance sheet of Bradford & Bingley at market value, based on quoted market prices where available. In closing out, the counterparties to repo agreements (economically, lenders to Bradford & Bingley) would have valued the collateral and returned to Bradford & Bingley any excess collateral, or lodged an unsecured claim to the administration if the value of the collateral was less than the debt owed under the repo agreement.

5.22. I have assumed that, with the exception of holdings of two debt securities, counterparties would have valued the debt securities held as collateral at the book value of the securities. The two holdings of debt securities that I treat as exceptions were holdings in Bradford & Bingley’s covered bond programme that were not publicly traded. Due to the lack of any reference point for their market value, these notes were recorded on the balance sheet at their nominal value of £0.6 billion. Around the transfer time, investment banks indicated that the market value of these notes would likely have been at a discount to nominal value of 15%. Based on this discount, the impact on the balance sheet of Bradford & Bingley on closing out the repo agreements would have been a loss of £0.1 billion.

5.23. I have assumed that the unencumbered debt securities held by Bradford & Bingley would have been disposed of within the first year of the administration and that the book value would have been realised, resulting in no further adjustment to the balance sheet.

Residual interests in secured funding arrangements

Summary: The initial balance sheet impact on the value of the residual interests in the secured funding arrangements would have been a loss of £0.3 billion in respect of the Barclays Senior Facility. No other losses would have been recognised in respect of other secured funding arrangements.

5.24. The implications of administration on the secured funding arrangements of Bradford & Bingley would have been complex and different for each of the arrangements. I provide a simplified summary of the implications of administration in the table below, before discussing the implications in more detail.

Figure 7: Impact of administration on the secured funding arrangements

Secured funding arrangement	Implications of administration
Secured warehouse facility with Barclays Bank plc ("Barclays Senior Facility")	Administration would trigger an event of default, allowing Barclays the right to accelerate the loan (demand repayment sooner) and enforce the security. Enforcement of security would include disposal of the collateral to realise proceeds to satisfy the amounts owed.
Covered Bond Programme	Administration would trigger an issuer event of default. The structure would continue but cash would be locked in the structure such that any residual interest held by Bradford & Bingley would be deferred and only available after all Covered Bonds are repaid in full. In addition, the bond trustee would place a claim against Bradford & Bingley for the full amount of notes outstanding.
Aire Valley Master Trust Programme	No material impact on administration as the structure is 'insolvency remote' (i.e. the structure continues to operate notwithstanding the insolvency of Bradford & Bingley).
Bowler Finance plc Asset Backed Programme ("Bowler Finance")	No material impact on administration as the structure is 'insolvency remote'.

Barclays Senior Facility

Summary: I consider that as a result of administration, following the enforcement of security on behalf of Barclays Bank plc under the Barclays Senior Facility, Bradford & Bingley would incur a loss of £0.3 billion.

5.25. Bradford & Bingley had borrowed £1.0 billion from Barclays Bank plc under the Barclays Senior Facility and had granted security over £1.7 billion of mortgage assets together with £0.2 billion of liquid assets as collateral in favour of a Security Trustee. The residual interest in the Barclays Senior Facility would thus have been £0.9 billion. An administration of Bradford & Bingley would have triggered an event of default, following which Barclays would have had the right to accelerate the loan made by them in full and trigger enforcement action. Enforcement of security would have meant the disposal of the assets over which security was granted to realise proceeds to repay Barclays.

5.26. I consider that Barclays would have sought repayment of the loan and enforced the security and that the proceeds realised would be sufficient to discharge the Barclays Senior Facility in full. As the markets were depressed at the time, I have assumed that the assets over which security was granted would have been able to be disposed of at a discount of approximately 15%. This is based on discounts being applied in transactions and attempted transactions around that time. I therefore expect the assets subject to security to have been disposed of for around £1.6 billion. This would result in a return of £0.6 billion of assets to Bradford & Bingley and a loss of around £0.3 billion.

Covered Bonds

Summary: I consider that Bradford & Bingley would not incur any initial balance sheet losses in respect of the covered bond programme.

5.27. Holders of Bradford & Bingley's covered bonds would not only have a general claim over the assets of Bradford & Bingley but also have recourse, in the event of an Issuer event of default (including administration), to a specified portfolio of assets. In an administration of Bradford & Bingley, the bond trustee (on behalf of covered bondholders) would place a claim for the full value of outstanding covered bonds, £8.9 billion, against Bradford & Bingley. The covered bond programme would continue to operate in a similar manner to the extent that sufficient funds were being generated to meet the scheduled payments of principal and interest under the covered bond programme, and the covered bondholders claim would reduce as scheduled interest and principal were paid on the covered bond.

5.28. If sufficient funds were not available, the bond trustee would require the disposal of assets to generate funds. However, in my favourable administration scenario, I consider it would not have been necessary to dispose of any mortgage assets to meet maturing covered bonds (thus avoiding any loss on forced disposals of residential mortgages, particularly in 2008 after the transfer time when offers would likely have been at a significant discount to the book value of loans). The residual interest of Bradford & Bingley in the covered bond programme of £12.7 billion would, therefore, not have suffered any initial losses as a result of administration.

5.29. The profits or losses in the covered bond programme during the course of the administration impact the eventual magnitude of the residual value due to Bradford & Bingley at the end of the administration and I have modelled the impact of the ongoing operation of the covered bond programme (as with the Aire Valley Master Trust and Bowler Finance). The outstanding externally held covered bonds in the covered bond programme at the end of the administration in 2018 would have been a relatively small sum (£0.3 billion) and I consider that at that time, with a small incentive remaining bondholders could be persuaded to agree to an early redemption of the covered bond structure such that, following payment of the outstanding covered bonds in 2018, the remaining cash in the covered bond programme would be returned to the administrator.

Aire Valley Master Trust

Summary: I consider that administration would not have a material impact on the operation of the Aire Valley Master Trust.

5.30. The Aire Valley Master Trust programme, established by Bradford & Bingley special purpose vehicles, issued residential mortgage backed securities to investors and used the proceeds to fund the purchase of mortgage loans by the Aire Valley Master Trust from Bradford & Bingley. The balance of mortgages within the Aire Valley Master Trust at 29 September 2008 was £12.8 billion with £10.4 billion of notes outstanding. Administration would result in the programme entering 'pass through', a status whereby principal is paid according to priority from principal receipts from mortgages as they are received. Any surplus of interest income from mortgages over interest paid to noteholders in accordance with their terms would be paid to Bradford & Bingley during the course of an administration.

5.31. I therefore do not believe that administration in itself results in any material change to the expected returns from the Aire Valley Master Trust to Bradford & Bingley. I have modelled the cash flows that would have been expected to have been distributed to Bradford & Bingley during the course of the administration by assessing the cash inflows from the mortgage portfolios (as discussed below) and the cash outflows to noteholders, in accordance with the terms of the notes.

Bowler Finance

Summary: I consider that an administration would not have a material impact on the operation of Bowler Finance.

5.32. The Bowler Finance programme, established by a Bradford & Bingley special purpose vehicle, issued residential mortgage backed securities to investors and used the proceeds to purchase mortgage loans from Bradford & Bingley. In this structure, all principal receipts from mortgages are allocated to notes on a 'pass through' basis. I consider that, as with the Aire Valley Master Trust, administration in itself does not result in any material change to the expected returns from the Bowler Finance programme to Bradford & Bingley.

Derivative financial instruments

Summary: Administration of Bradford & Bingley would have triggered an event of default and derivative positions would have then been terminated by counterparties resulting in a balance sheet loss of £0.3 billion.

5.33. Administration of Bradford & Bingley would have triggered an event of default and derivative financial instrument ("derivative") positions would almost certainly have been terminated by counterparties. On termination counterparties who held asset positions would have lodged a claim against the administration of Bradford & Bingley for the value of the derivatives, and those who had a liability position would have paid the administration of Bradford & Bingley to terminate their positions. I note where counterparties had a liability to Bradford & Bingley, they may have sought to delay or reduce amounts payable by them.

5.34. In terminating the derivative positions counterparties would have submitted a value for the outstanding position that would take into account the significant costs associated with exiting positions and replacing Bradford & Bingley as the counterparty. This would have resulted in losses for Bradford & Bingley due to derivative balances being valued on the balance sheet on a 'mid market' basis in line with accounting standard requirements rather than an exit or replacement basis. I have assessed that the cash received from the asset derivative position would have been £0.7 billion (a loss of £0.1 billion) and the value of the unsecured administration claim of derivative counterparties would have been £0.8 billion (a loss of £0.2 billion). The total impact on Bradford & Bingley would have been a loss of £0.3 billion.

Defined benefit pension liability

Summary: Administration would have triggered a winding up of the defined benefit pension scheme resulting in a claim to the administration of £0.3 billion.

5.35. Bradford & Bingley had a defined benefit pension scheme with a deficit (being the difference between the plan assets and plan liabilities) of £11 million. In administration, the trustees of the pension scheme would trigger a winding up of the scheme so that it would become an unsecured creditor on the administration of Bradford & Bingley in the amount of a (Pensions Act) section 75 debt. The impact of the section 75 debt would be to increase the pension plan deficit to at least £0.3 billion.

Tax assets

Summary: Tax assets would be of no worth in administration and the resulting reduction in the assets of Bradford & Bingley would have been £0.3 billion.

5.36. Based on my assessment, I consider that there would not be any taxable profits during the course of administration and therefore no tax charge. The tax assets on the balance sheet would therefore be of no value, resulting in a reduction in the value of assets of £0.3 billion.

Disposal of deposit book and branch closure

Summary: My Statutory Assumptions lead me to conclude that it would not have been possible to dispose of the deposits with the branch network and therefore an administrator would have incurred costs of closing the branch network of approximately £30 million.

5.37. An administrator would consider the possibility of disposing of the retail deposits and branch network to another financial institution. Such a transaction would be advantageous to the administration process on two levels. Firstly, the removal of the branch network would significantly reduce ongoing staff and infrastructure costs. Secondly, transferring the network rather than closing it avoids such costs as redundancy costs and lease break payments, which would be incurred in closing the network.

5.38. Under the Transfer Order, the branch network and retail deposit business of Bradford & Bingley (including that in the Isle of Man) were sold to Abbey. The sale proceeds from this transaction were £612 million, allowing for the recognition of a gain on disposal of £216 million[16]. In order to complete the transaction, the FSCS and HMT agreed to fund the transaction. Drawing on a facility from HMT, FSCS paid to Abbey £14 billion, being an estimate of protected deposits, whilst HMT paid to Abbey the balance of around £4 billion, allowing a transfer to Abbey of £18 billion of deposits. Abbey agreed to operate the branch infrastructure and serve its depositors.

5.39. I have considered whether a similar sale could have been achieved within an administration process. As at 29 September 2008, the FSCS did not have the resources to fund a transfer of the deposit book without recourse to additional HMT funding or the ability to raise the resources through a levy. Through my discussions with the FSCS I understand that if Bradford & Bingley had entered administration, then it might have been possible to accelerate changes that subsequently took place to allow the FSCS to fund such a transfer in the interests of financial stability. However, given the level of market disruption and general shortage of liquidity and that the FSCS maximum annual levy capacity was approximately £4 billion, the only credible sources of funding for the FSCS would have been either HMT or the Bank of England. I am required to assess compensation under the Statutory Assumption that no financial assistance would in future be provided by the Bank of England or HMT to Bradford & Bingley (apart from ordinary market assistance offered by the Bank of England subject to its usual terms). I have determined that funding the transfer of the deposit book would constitute financial assistance (and would not be ordinary market assistance). I have therefore concluded that the FSCS would not have funded any transfer of the deposit book and that the transfer would not have occurred.

[16] Bradford & Bingley audited financial statements 2008

5.40. In the absence of being able to transfer the deposit book and branches, I estimate the overall impact of closing the branches of Bradford & Bingley would be a cost of at least £30 million based on statutory staff redundancy levels and an estimate of lease termination costs.

Potential to generate profits over the course of the administration

Summary: I conclude that, in administration, post-administration interest accruing on outstanding liabilities of Bradford & Bingley would exceed the profits generated by the run-off of the customer loans.

5.41. Having decided that an administrator would continue to manage the customer loans and not seek an immediate sale, I have assessed the extent to which Bradford & Bingley would have been able to generate profits in administration that might allow for the recognition of a surplus over the liabilities. In order to make this assessment I have developed a financial model to forecast the cash flows and associated profits or losses that would have been generated from the run-off of the mortgage book over a ten year administration period.

5.42. The principal items of revenue and cost resulting from the run-off of the customer loans are set out as follows.

- Interest income from customers: borrowers would continue to pay interest (as well as principal) on their loans to Bradford & Bingley. This would generate significant income.

- Net interest income from the secured funding arrangements: I have assessed the excess of interest income over the interest expense that would be expected to be paid to third party noteholders within each of the secured funding arrangements over the course of the administration. By that means I have assessed the interest available that would be payable to Bradford & Bingley.

- Post-administration interest expense: I calculate that there would be a surplus of cash at the end of the ten year administration with which to pay some post-administration interest on outstanding liabilities. Bradford & Bingley would have accrued post-administration interest throughout the administration period at the greater of the applicable statutory rate of 8% per annum as at the transfer time and the rate applicable to the debt apart from the administration.

- Loan losses: a number of customers would have fallen into arrears by failing to meet their monthly interest (or interest and principal depending on the nature of the particular customer loan) payments due. A number of those customers in arrears would have subsequently defaulted. In these situations, Bradford & Bingley would have enforced their security arrangements and disposed of the properties. In such forced sale situations significant discounts would generally have been suffered. Where the value of the outstanding principal on loans exceeded the value realised for the property held as security this would have resulted in losses. Through Bradford & Bingley's residual interests in the secured funding arrangements, Bradford & Bingley would have suffered the losses on customer loans within these arrangements as well as those on the unencumbered customer loans controlled by the administrator.

- Operating costs: during the course of the administration the business of Bradford & Bingley would continue and operating costs would be incurred. I have assumed that such operating costs would be significantly reduced from those of Bradford & Bingley prior to September 2008, due to the closure of branches and significant redundancies associated with such closure.

- Corporation Tax: even in my favourable scenario the accrued post-administration interest would have exceeded net profits from the other items set out previously. Consequently there would be no taxable profits.

Performance of customer loans

5.43. There would be a lack of certainty as to how Bradford & Bingley's customer loans would perform in a recession. To assess performance I have modelled the performance of the unencumbered customer loans and the customer loans held by each of the secured funding vehicles separately by reference to particular economic and other parameters. The performance of the mortgage book through the administration is a key determinant of the ability of Bradford & Bingley to generate cash through the run-off. The table below sets out the most important parameters that I have considered in assessing the financial implications of the run-off of the customer loans.

Figure 8: Parameters considered in assessing the run-off of customer loans

Parameter	Approach
Interest rates: Bank of England Base Rate (BBR), LIBOR and Bradford & Bingley's Standard Variable Rate (SVR)	Interest income is primarily driven by products linked to BBR or LIBOR. These rates have been forecast based on expectations of the economic conditions at the time, through the use of a macroeconomic model.
Loan loss provisions: probability of default and loss given default	Based on Bradford & Bingley and UK mortgage market historical performance data and forecast economic conditions, I have estimated the development of arrears in the Bradford & Bingley mortgage book. This, combined with analysis of the historic rate at which properties have moved into repossession from the arrears state, is the basis for my estimating the probability of default. For cases in default, it is unlikely the full amount of a loan outstanding will be recovered, resulting in a loss to Bradford & Bingley. We have estimated the expected loss based on forecast house price movements and Bradford & Bingley's historical experience in relation to time to recovery of proceeds, forced sale discounts and associated costs in repossession.
Contractual and non-contractual redemptions	A portion of mortgage customers redeem prior to maturity, accelerating the cash flow to Bradford & Bingley. Based on analysis of historical redemption rates and review of Bradford & Bingley forecasts, I have estimated redemption rates consistent with the forecast economic conditions.

5.44. I have considered the potentially adverse impact that administration of Bradford & Bingley might have had on mortgage customer behaviour. I have assumed no such adverse impact.

Conclusion

5.45. I consider that an administration of Bradford & Bingley would allow for the repayment of the principal outstanding on all debts (excluding perpetual subordinated bonds and undated subordinated notes) and would generate in the region of £5 billion to meet post-administration interest. The effective yield for creditors would be a yield of approximately 2.7%. This is significantly below the statutory rate of 8% of the debts described above at which interest would accrue to creditors. Accordingly, no residual surplus would be available for distribution to holders of perpetual subordinated bonds, holders of undated subordinated notes or shareholders.

5.46. I therefore conclude that in administration equity would receive no distributions, and therefore there is no compensation due to shareholders and holders of subscription rights.

6. My assessment of compensation

6.1. Having regard to the Statutory Assumptions, I have concluded that as at the transfer time Bradford & Bingley would have been unable to continue as a going concern. I have determined that it would have gone into administration before or shortly after the transfer time. That process would allow for the repayment of the principal outstanding on all Bradford & Bingley's debts (excluding perpetual subordinated bonds and undated subordinated notes) and would generate in the region of £5 billion to meet post-administration interest. Eligible creditors would receive a return equivalent to a yield in the region of 3.2%. This is significantly below the statutory rate of 8% at which post-administration interest accrues to such creditors.

6.2. Accordingly, no residual surplus would be available for distribution to shareholders.

6.3. I therefore determine that:

(i) immediately before the transfer time the ordinary shares in Bradford & Bingley had no value; and

(ii) it follows that immediately before the transfer time the subscription rights also had no value.

6.4. I therefore determine that no compensation is payable under the Scheme to shareholders or to holders of subscriptions rights.