The Bradford & Bingley plc Compensation Scheme

Independent Valuer – Peter J Clokey

Assessment Notice in respect of extinguished rights relating to dated subordinated notes

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 this Assessment Notice.

This document has been prepared by Peter J Clokey as independent valuer for the purposes of the Bradford & Bingley plc Compensation Scheme established under The Bradford & Bingley plc Compensation Scheme Order 2008 (as amended).

This document is an Assessment Notice issued pursuant to paragraph 10 of the Schedule to The Bradford & Bingley plc Compensation Scheme Order 2008 (as amended) and should not be used or relied on for any other purpose.

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 whose rights in relation to certain dated subordinated notes ("holders of rights associated with dated subordinated notes") were extinguished by virtue of the provision made in articles 6 or 7 of The Bradford & Bingley plc Transfer of Securities and Property etc. Order 2008 (as amended) (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 plc ("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 compensation.

Modification of interests, rights and liabilities associated with the dated subordinated notes

2.1. Paragraph 5 of the Schedule to the Compensation Scheme Order provides for the determination of any compensation payable by HMT to persons whose rights (referred to in paragraph 5 as "consequential rights") were extinguished by virtue of the provision made in articles 6 or 7 of the Transfer Order. Paragraph 5 provides that the amount of compensation payable shall be such compensation as may be just in respect of that person's consequential rights and that compensation is payable in respect of a person's consequential rights only if such compensation is required to be paid to comply with the Convention rights (within the meaning given by section 1 of the Human Rights Act 1998).

2.2. Paragraph 5 further provides that the determination of any compensation in respect of consequential rights shall take into account any diminution in the value of property or any increase in the burden of any liability which, in each case, is attributable to certain consequences specified in paragraph 3 of article 7 of the Transfer Order not arising.

2.3. Article 6 of the Transfer Order applies to "dated subordinated notes". The following issues of debt by Bradford & Bingley fall within the definition of such instruments[1]:

- the £125,000,000 7.625 per cent. subordinated notes due February 2010;
- the £125,000,000 6.625 per cent. subordinated notes due 16 June 2023;
- the £200,000,000 fixed-rate step-up subordinated notes due 12 December 2022;
- the £150,000,000 floating rate dated subordinated notes due March 2054; and
- the £250,000,000 fixed rate/floating rate callable step-up dated subordinated notes due January 2018.

2.4. Article 6 of the Transfer Order modified the rights and liabilities associated with the dated subordinated notes with effect from 8.00 a.m. on 29 September 2008 (the "transfer time", as defined in paragraph 2 of the Schedule to the Compensation Scheme Order[2]). Article 6 originally provided that a default in the payment of any principal due in respect of a dated subordinated note shall not constitute an event of default under the note and shall not give rise to certain consequences specified in paragraph 3 of article 7 of the Transfer Order. Article 6 was amended with effect from 20 February 2009 to replace these provisions with new provisions that provided for various matters including that principal and interest due in respect of a dated subordinated note shall not become due and payable unless certain conditions are satisfied.

2.5. In summary, article 7 of the Transfer Order provides that certain consequences specified in paragraph 3 of article 7 shall not arise in respect of any "relevant instrument" as a result of the transfer of ordinary shares in Bradford & Bingley to the Treasury Solicitor as nominee of HMT under article 3 of the Transfer Order or any other thing done, or matter arising, by virtue of or in connection with that transfer. The term "relevant instrument" includes the dated subordinated notes.

Statutory assumptions

2.6. Section 5(4) of the Banking (Special Provisions) Act 2008 (the "Act") provides that in determining the amount

[1] The definition of "dated subordinated notes" also includes any further subordinated debt issued by Bradford & Bingley which ranks or is expressed to rank *pari passu* with any of the notes listed above. I am not aware of any such debt having been issued.
[2] I have adopted this definition of "transfer time" in the rest of this document.

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".

2.7. "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.

2.8. 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"[3]. 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.

2.9. 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] Bank of England News Release – Special Liquidity Scheme: 21 April 2008

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[4] (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. Amongst 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

[4] 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

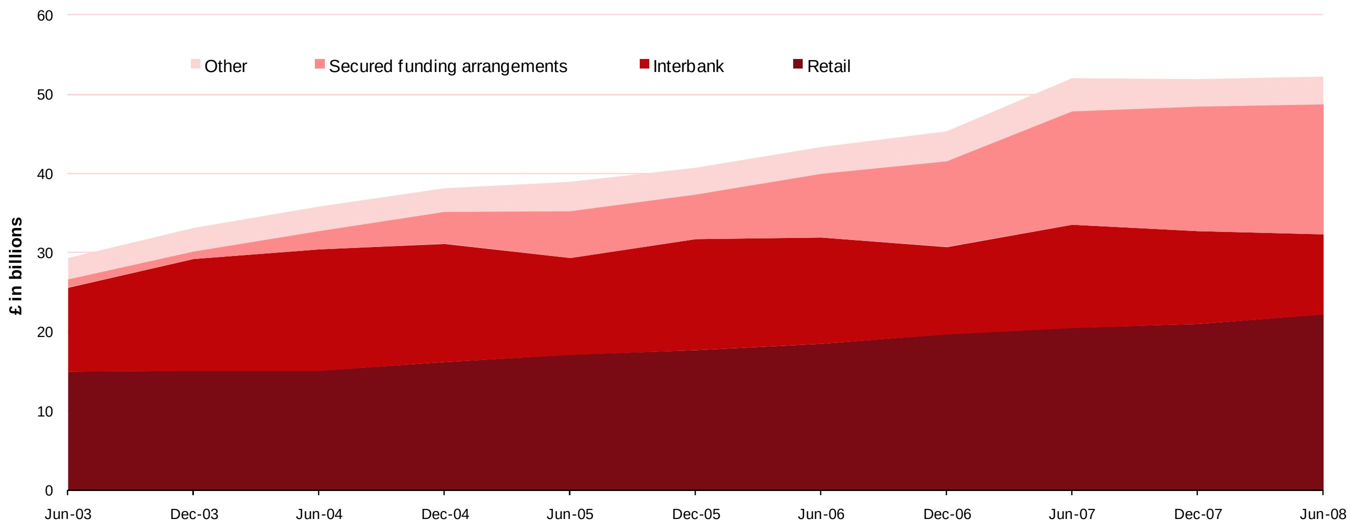
3.5. Principal sources of bank funding are retail and commercial deposits. Like many other mortgage banks, Bradford & Bingley also obtained funding through the interbank market and structured capital markets arrangements. Such funding included a secured warehouse facility with Barclays Bank plc and the 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[5] 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 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[6] 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[7].

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

Rights issue

3.11. These losses would have resulted in a further deterioration in the capital position of the Group if it were not 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%[8], a level that compared favourably with other UK banks and one that the Board regarded as being adequate[9].

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[10]. 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[11]. 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[12]. 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[13]. 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."[14] 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."[15]

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:

---

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

"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[16] (the "threshold conditions") in that, in the opinion of the FSA, it has not satisfied the 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

[16] The Act referred to here is the Financial Services and Markets Act 2000

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 a liquidation and any private sector solution.

3.22. I do not think that a 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 6 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 focussed 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.

4. Rights extinguished by the Transfer Order

Summary

The impact of the Transfer Order has been to extinguish various rights associated with the dated subordinated notes, in particular the basis on which principal and interest is payable.

Impact of the Transfer Order

4.1. Paragraph 5 of the Schedule to the Compensation Scheme Order provides for the determination of any compensation payable by HMT to persons whose rights associated with the dated subordinated notes were extinguished[17] by virtue of the provision made in articles 6 or 7 of the Transfer Order. I have summarised the effect of paragraph 5 in section 2 above. It requires me first to determine the amount of compensation, if any, that may be just in respect of the extinguishment of those rights, taking into account any diminution in the value of the dated subordinated notes or any increase in the burden of any liability which, in each case, is attributable to certain consequences specified in paragraph 3 of article 7 of the Transfer Order not arising. If I determine that an amount of compensation may be just, I must then decide whether such compensation is required to be paid to comply with the Convention rights (within the meaning given by section 1 of the Human Rights Act 1998).

4.2. My starting point, therefore, is to consider what rights associated with the dated subordinated notes have been extinguished by virtue of the provision made in articles 6 or 7 of the Transfer Order. Because article 6 of the Transfer Order was amended on 20 February 2009, it is convenient to consider this issue by reference to two periods: (i) 29 September 2008 (the date the Transfer Order came into force) to 19 February 2009 (the last date on which article 6 was in force in its unamended form) and (ii) 20 February 2009 (the date that the amended article 6 came into force) to 2 July 2010, being the reference date that I have fixed for the purposes of my assessment of compensation, as explained in paragraph 5.8 below. I consider each of these periods separately below.

Extinguishment of rights: 29 September 2008 to 19 February 2009

Article 6

4.3. As I summarise in paragraph 2.4 above, when it came into force on 29 September 2008, article 6 of the Transfer Order provided that a default in the payment of any principal due in respect of a dated subordinated note shall not (i) constitute an event of default under the note, or (ii) give rise to certain consequences specified in paragraph 3 of article 7 of the Transfer Order.

Event of default and specified consequences

4.4. The words “event of default under the note” in article 6 are not defined in the Transfer Order. I have interpreted these words to mean the events referred to in the definition of “Event of Default” in the contractual documentation relating to each of the dated subordinated notes. These events include, in relation to each of the dated subordinated notes, where a default is made for a period of seven or more days in the payment of any principal due in respect of those dated subordinated notes (the “Failure to Pay Event”). I have therefore interpreted article 6 as having the effect that the Failure to Pay Event does not constitute an “Event of Default” in respect of the dated subordinated notes.

4.5. Under the contractual documentation relating to each of the dated subordinated notes, the occurrence and continuation of an Event of Default gives rise to various rights on the part of the trustee (and, in some cases, the noteholders if the trustee fails to exercise its rights when it is bound to do so provided, in specified cases, that the trustee is indemnified). In particular, the trustee may require certain agents appointed by the issuer

[17] Although article 6 of the Transfer Order (in contrast to article 5) does not use the word “extinguished” but refers to rights and liabilities being “modified” and although the heading of paragraph 5 of the Schedule to the Compensation Scheme Order refers to “modification”, paragraph 5 itself refers to rights that have been “extinguished”. Compensation may only be payable under paragraph 5 in respect of extinguished rights.

to take certain actions, the trustee may require access to the issuer's books of account, and/or the trustee may cause the notes immediately to become due and payable at their nominal amount[18] together with accrued interest (if any) and, having done so, to institute proceedings for the winding-up of the issuer in England to enforce the issuer's obligations.

4.6. The consequences specified in paragraph 3 of article 7 of the Transfer Order in respect of each of the dated subordinated notes to which a default in the payment of any principal due in respect of those notes would give rise (and which article 6 provided could not arise) are essentially the same rights as are described at paragraph 4.5 above.

4.7. Insofar as these rights were capable of being triggered by the Failure to Pay Event, I consider that they were extinguished by virtue of the provision made in article 6 during the period 29 September 2008 to 19 February 2009. In relation to these rights, I consider that the right to cause the notes immediately to become due and payable and the consequent rights to institute winding-up proceedings are the most important of the extinguished rights.

Article 7

4.8. I have considered whether any rights associated with the dated subordinated notes have been extinguished by virtue of the provision made in article 7 of the Transfer Order. Such rights would only have been extinguished if the consequences specified in paragraph 3 of article 7 of the Transfer Order would have arisen (in the absence of article 7) in respect of a dated subordinated note as a result of the transfer of ordinary shares in Bradford & Bingley to the Treasury Solicitor as nominee of HMT under article 3 of the Transfer Order, or any other thing done, or matter arising, by virtue of or in connection with that transfer.

4.9. I do not consider that any of the consequences specified in paragraph 3 of article 7 of the Transfer Order would have arisen in this way in respect of the dated subordinated notes. I therefore conclude that no rights associated with the dated subordinated notes were extinguished by virtue of the provision made in article 7 during the period 29 September 2008 to 19 February 2009.

Extinguishment of rights: 20 February 2009 to 2 July 2010

Article 6

4.10. Article 6 of the Transfer Order was amended with effect from 20 February 2009 to replace the original provisions with new provisions. The effect of the relevant provisions of the amended article 6 is summarised below:

(i) Under the contractual documentation relating to each of the dated subordinated notes, principal was due to be paid in a single payment at the maturity date (unless the payment obligation was accelerated) and interest was due to be paid on specified periodic payment dates (again subject to acceleration). From 20 February 2009 article 6 extinguished the right to payment of principal and interest on this basis by providing that the principal and interest due in respect of a dated subordinated note shall not become due and payable except where:

(a) Bradford & Bingley notifies the holder of a dated subordinated note that the principal or interest (or any part of either) is to be due and payable (whereupon the payment is due on the date specified by Bradford & Bingley), or Bradford & Bingley has satisfied in full its liability to the FSCS under article 30(1) of the Transfer Order; and

(b) Bradford & Bingley could make the payment of principal or interest and continue to be solvent thereafter (and for this purpose Bradford & Bingley is not solvent if it would be deemed unable to pay its debts within the meaning given by section 123 of the Insolvency Act 1986).

(ii) The amended article 6 provides that in a winding-up of, or on a distribution by an administrator appointed in respect of, Bradford & Bingley there shall be payable in respect of each dated subordinated note such amount as would be payable to a holder of a preference share in Bradford

[18] It should be noted, however, that for each of the dated subordinated notes the nominal amount is payable in a single payment on the maturity date. It follows that, for the Failure to Pay Event to have arisen, the nominal amount must already have been due and payable in full.

& Bingley ranking ahead of all other issued shares of Bradford & Bingley (including any other preference shares or any notional shares), on the assumption that such preference share was entitled to an amount equal to the principal amount of such dated subordinated note together with any interest which has accrued up to the day of repayment. This represents a change to the rights of the holders of rights associated with dated subordinated notes under the relevant contractual documentation. Under that documentation the dated subordinated notes ranked ahead of undated subordinated securities and perpetual subordinated bonds. The effect of the amended article 6 is to change that priority so that the dated subordinated notes rank pari passu with these other instruments.

4.11. I consider that these rights were extinguished by virtue of the provision made in article 6 during the period 20 February 2009 to 2 July 2010.

Article 7

4.12. The analysis is the same as at paragraphs 4.8 and 4.9 above. I therefore conclude that no rights associated with the dated subordinated notes have been extinguished by virtue of the provision made in article 7 during the period 20 February 2009 to 2 July 2010.

5. My approach to compensation

Summary

I concluded in section 3 that in the absence of the Transfer Order Bradford & Bingley would have gone into administration. In this section I set out how I assess the amount of any compensation which may be just in respect of the extinguished rights. I have determined that compensation would only be just if the extinguishment of rights caused a loss of economic value. To establish whether there is any loss of economic value I compare the amount and timing of distributions from public ownership against the administration distributions.

Determining just compensation

5.1. In determining the amount of compensation, if any, that may be just in respect of the extinguishment of those rights identified in section 4, I am required to take into account any diminution in the value of the dated subordinated notes or any increase in the burden of any liability which is attributable to the consequences specified in paragraph 3 of article 7 of the Transfer Order not arising. I consider below whether there has been any relevant diminution in the value of the dated subordinated notes. I consider that there has not been any relevant increase in the burden of any liability. I have identified at paragraph 4.6 above the specified consequences for the period 29 September 2008 to 19 February 2009. In summary, the specified consequences for the period 20 February 2009 to 2 July 2010 are the extinguishment of the right to payment of principal and interest on the basis provided for by the contractual documentation (see paragraph 4.10(i) above) (together with the associated enforcement rights) and the priority rights referred to at paragraph 4.10(ii) above. Since I have concluded that they are essentially the same, I do not distinguish later in this document between the extinguished rights and the specified consequences.

5.2. There is no statutory guidance as to how I should determine what compensation is just, other than the requirement to take into account the matters specified in paragraphs 2.1 and 5.1 above. In order to determine just compensation I consider that I must first determine whether and to what extent a loss of economic value has been suffered as a result of the extinguishment of the various rights identified above. This approach gives effect to the statutory requirement to have regard to any diminution in the value of the dated subordinated notes. Only if I determine that a loss of economic value has been suffered, would I then consider that any compensation would be just in respect of the extinguished rights.

5.3. To determine whether any compensation is just I consider that it is appropriate to assess the overall effect of the Transfer Order including the extinguishment of rights identified above and also the benefits that are conferred on holders of rights associated with dated subordinated notes by virtue of the public ownership. In view of this consideration it is appropriate that I establish whether any loss of economic value has been caused through a comparison of the economic prospects of holders of rights associated with dated subordinated notes with Bradford & Bingley in public ownership (the “factual position”) against the economic prospects had Bradford & Bingley entered administration either before or shortly after the transfer time (the “counterfactual position”).

5.4. As described in paragraph 2.6 above, in determining the amount of any compensation I am required to 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 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). In my view it is appropriate to give effect to the Statutory Assumptions by assuming, in the context of the counterfactual position, that at the time Bradford & Bingley goes into administration assistance to Bradford & Bingley through the SLS has been withdrawn and no such assistance would be provided in the future.

5.5. In order to make the comparison referred to in paragraph 5.3 above, I have considered the amount and timing of:

- future distributions that I expect holders of rights associated with dated subordinated notes to receive in public ownership together with those amounts already received since the transfer time. I refer to these distributions as the “distributions from public ownership”; and

- future distributions that I expect holders of rights associated with dated subordinated notes would have received had Bradford & Bingley gone into administration in September 2008. I refer to these distributions as the "administration distributions".

5.6. I then consider the present value as at the reference date (described below) of the distributions from public ownership and the administration distributions, on a series by series basis.

5.7. If through this comparison I conclude that there has been no loss in economic value suffered by holders of rights associated with dated subordinated notes then I determine that no compensation would be just in respect of the extinguished rights.

Reference date

5.8. There is no statutory date as at which I am required to assess compensation in relation to rights associated with dated subordinated notes. I consider, however, that it is important that I include all information that might be relevant to an assessment of loss of economic value that is available to me. Accordingly, I have adopted 2 July 2010, being the last business day before the date of this Assessment Notice, as my reference date.

Basis of forecasts: public ownership

5.9. In determining the prospects of holders of rights associated with dated subordinated notes while Bradford & Bingley is in public ownership, I have considered the forecasts included within the business plan for Bradford & Bingley that was approved by the Board on 25 May 2010 (the "business plan") together with my own assessment of the prospects for holders of rights associated with dated subordinated notes as at 2 July 2010.

Basis of forecasts: administration

5.10. I have assessed the distributions that holders of rights associated with dated subordinated notes might receive in an administration through the development of a favourable administration scenario: "my administration scenario", as described below in paragraphs 5.11 and 5.12 below.

5.11. In developing my administration scenario I have considered the business plan base case forecasts as a starting point and constructed a model, as at my reference date of 2 July 2010, to establish the administration distributions. In doing so I have taken into account factors that would lead to a different outcome in administration and I discuss the most important of these in section 6.

5.12. In addition, I have adopted assumptions which I regard to be reasonable but that would result in a favourable outcome for holders of rights associated with dated subordinated notes. I consider that adopting this scenario as the counterfactual is appropriate for the comparison that I undertake in section 6 below in that it allows me to assess whether there might have been a scenario under which the present value of administration distributions would exceed the present value of distributions from public ownership. I recognise that there is a higher level of downside risk than upside potential in my administration scenario which would require the application of a higher discount rate in order to assess the present value.

The traded price and tender offer in respect of the dated subordinated notes

5.13. Four of the five series of dated subordinated notes were traded and continued to trade after the transfer time. The traded prices of these notes began to fall gradually from early September 2008 before suffering a sharp fall around the transfer time. Furthermore, the traded prices of the dated subordinated notes fell again following the amendment to the Transfer Order.

5.14. As set out above, it is my view that a payment of compensation would only be just if I determine there has been a loss in economic value suffered by holders of rights associated with dated subordinated notes (as demonstrated by a comparison of the present value of administration distributions against the present value of distributions from public ownership). This approach allows me to assess the overall effect of the Transfer Order including the extinguishment of rights identified above but also the benefits that are conferred on holders of rights associated with dated subordinated notes by virtue of the public ownership. Basing an assessment of compensation on rises and falls from time to time in the traded price of any dated subordinated note (including any losses crystallised by a decision to buy or sell at any particular time) would not allow me properly to take into account the overall effect of the Transfer Order or give effect to the Statutory Assumptions.

5.15. On 16 June 2010 Bradford & Bingley announced that it would accept for purchase all notes validly tendered pursuant to invitations by Bradford & Bingley to tender certain notes (including four of the five series of dated subordinated notes) for cash; the final deadline for receipt of valid tender instructions was the previous day. The tender offer was at a premium to the traded prices of the relevant dated subordinated notes and many holders of rights associated with dated subordinated notes chose to tender their securities. I have assessed this tender offer to determine whether it has any bearing on my assessment of compensation. For the reasons set out at paragraph 5.14 above, I have decided that it does not assist me in assessing the extent of any loss of economic value suffered by holders of rights associated with dated subordinated notes.

6. Dated subordinated notes: administration and public ownership

Summary

In this section I set out why I have concluded that the present value of distributions from public ownership would exceed the present value of administration distributions. I therefore conclude that there has been no loss of economic value as a result of the extinguishment of rights associated with dated subordinated notes.

Introduction

6.1. In order to determine whether compensation is required to be paid to the holders of rights associated with dated subordinated notes I have assessed the present value of administration distributions and distributions from public ownership.

6.2. There is no certainty in relation to the timing of future distributions under public ownership or in my administration scenario. The Board has adopted a run-off strategy, which is similar to that which an administrator might take and therefore it is appropriate that I consider a similar timeframe for final distributions in both scenarios.

Bradford & Bingley in public ownership

6.3. Bradford & Bingley's strategic priorities were revised as a result of being taken into public ownership. On the sale of the deposit business and branch network, £18.4 billion of retail deposits were replaced with interest-free funding provided by the FSCS (the "Statutory Debt"). This was required to allow the onward transfer of the deposit business to Abbey. Bradford & Bingley also received a working capital facility from HMT of £11.5 billion.

6.4. In the business plan, Bradford & Bingley states that the:

> "overarching objectives are to repay the Working Capital Facility to HM Treasury and the Statutory Debt to the FSCS and HM Treasury as soon as market conditions allow, and to protect the taxpayer, whilst also treating customers and creditors fairly."[19]

In order to achieve these goals Bradford & Bingley has ceased new lending and is running off its balance sheet.

6.5. In 2009 the Group (as constituted post-Transfer Order) made an operating loss before tax of £196 million. This was largely due to a continued high level of loan impairments, which amounted to £594 million compared to £508 million in 2008. Net interest income fell by 17% due to the aggregate effect of lower interest rates in respect of mortgage loans (representing the key income for the Group) being greater than the reduction in the cost of funding as a result of interest-accruing deposit funding being replaced by interest-free Statutory Debt.

Business plan of Bradford & Bingley

6.6. I have reviewed the key assumptions underlying the forecast financial performance and overall outcome under the different economic scenarios set out in the business plan. I consider the business plan forecasts form a reasonable starting point for my assessment of the prospects for the holders of rights associated with dated subordinated notes under both public ownership and administration.

Prospects of dated subordinated notes under public ownership

In public ownership I expect Bradford & Bingley to repay the full principal outstanding and to pay all accrued interest.

[19] Bradford & Bingley business plan, March 2009

The business plan includes the accrual of interest on a compound basis and I have determined that it is appropriate that I assume the same for my assessment.

Overall profitability

6.7. The Group benefits from the interest-free Statutory Debt and is forecast to continue to benefit from this over the ten year period covered by the business plan. The business plan also forecasts that loan impairments will fall as the economy improves and house price inflation returns. The combination of these two factors results in an expectation that the Group will generate significant levels of profit over the ten year period. There is no plan to pay dividends in the business plan and hence equity (through retained earnings) accumulates over time.

6.8. Bradford & Bingley has developed seven scenarios, including a base case scenario, a positive scenario and five stress scenarios of varying severity. These scenarios reflect economic and business performance uncertainty. I have reviewed these scenarios and the parameters on which they are based and consider that they form a reasonable basis for my assessment. I note that Bradford & Bingley is expected to retain profits and increase equity over this period in all scenarios.

Distributions to holders of dated subordinated notes

6.9. Figure 4 sets out the dated subordinated notes and the payments made following the transfer time.

Figure 4: Dated subordinated notes payments post Transfer Order

Bond description	Frequency	Payments	Amounts paid (£ in millions)
£125,000,000 7.625 per cent. Subordinated notes due February 2010	Annual	16 Feb 09	9.5
£125,000,000 6.625 per cent. Subordinated notes due 16 June 2023	Annual	No payments since Transfer Order	
£200,000,000 fixed rate step-up subordinated notes due 12 December 2022	Annual	12 Dec 08	11.5
£150,000,000 floating rate dated subordinated notes due March 2054	Quarterly	30 Sep 08	2.7
		31 Dec 08	2.9
		31 Mar 09	1.5
£250,000,000 fixed rate/floating rate callable step-up dated subordinated notes due January 2018	Annual	15 Jan 09	13.8

6.10. Bradford & Bingley continued to make interest payments on the dated subordinated notes from September 2008 to March 2009.

6.11. I have included the interest payments made between September 2008 and March 2009, together with those that I expect to be made after the reference date, in assessing the distributions from public ownership in respect of each series of dated subordinated notes.

6.12. The business plan includes a forecast for the accrual of interest on a compound basis in respect of dated subordinated notes. These forecasts indicate that Bradford & Bingley expects to repay all outstanding principal and pay all accrued interest in respect of the dated subordinated notes.

6.13. The timing of the payment of accrued interest and principal is not certain. In particular, following the approval of the aid provided by the UK Government to Bradford & Bingley under State aid rules announced by the European Commission on 25 January 2010, Bradford & Bingley announced on 23 February 2010 that:

> “The Company has now resolved not to make any payment of interest or principal on any of its Subordinated Notes during the period prior to the date on which it repays in full its liability to the Financial Services Compensation Scheme”.

6.14. The business plan sets out forecasts on the basis that there is no significant disposal of mortgage assets. The forecasts reflect a run-off of the mortgage book that would not generate sufficient funds to extinguish the liability to the FSCS by 2018. I have considered the balance sheet position that would have developed by 2018 and believe that it would be possible to generate sufficient funds at this time through the disposal of assets to discharge all liabilities, including the interest accrued on the dated subordinated debt, and that doing so would be consistent with the objectives under public ownership as set out in paragraph 6.4. As discussed at paragraph 6.29 below, I consider that a run-off of the mortgage book would take place over a period of five to ten years. In my administration scenario I have assumed a ten year period and adopt the same period for public ownership. I have therefore made an assumption that Bradford & Bingley would repay in full principal and pay all accrued interest in 2018. In forming my overall conclusions I have also considered the sensitivity of differing timeframes associated with public ownership and administration on my analysis.

Risk associated with the business plan forecasts

6.15. There is a risk in public ownership that assets are sold earlier than set out in the business plan or at a discount to their balance sheet book value, particularly given the stated overarching objectives of public ownership are to continue to repay the working capital facility provided by HMT and the Statutory Debt as soon as market conditions allow. This risk is mitigated, however, by the following factors:

- the directors of Bradford & Bingley have an obligation to treat all of the creditors fairly, including the holders of rights associated with dated subordinated notes; and
- the prospects of the dated subordinated notes are enhanced by the equity growth that is expected by virtue of the interest-free Statutory Debt, even in the most stressed scenario included in the business plan.

Prospects under administration

I have concluded that Bradford & Bingley would repay in full all debts proven in the administration (including in respect of the dated subordinated notes) and, to the extent surplus is available, make a payment of post-administration interest. I have determined that the administration distributions for each series of dated subordinated notes would be lower than the distributions from public ownership.

Objective of the administrator

6.16. I have determined that in the absence of the Transfer Order Bradford & Bingley would have entered administration. The holders of rights associated with dated subordinated notes would be paid from the proceeds of the administration after the administration had met all obligations in respect of proven claims of all creditors (other than subordinated creditors) of Bradford & Bingley.

6.17. 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.

6.18. 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.

6.19. 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

6.20. Following entry into administration, the funds realised from the assets of Bradford & Bingley would be distributed in the following order of priority[20]:

- 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;
- Bradford & Bingley's ordinary unsecured creditors;
- dated subordinated noteholders;
- post-administration interest;
- holders of perpetual subordinated bonds and undated subordinated note holders; and
- shareholders.

Post-administration interest

6.21. 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.

6.22. 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.

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

Administration strategy

6.23. I have considered the strategy that would be adopted by an administrator to maximise value for the creditors. In developing my administration scenario I have determined that an administrator would maximise value for creditors through the selective management of or, in some cases, disposal of Bradford & Bingley's assets.

6.24. I have considered the consequences of the entry into administration on the assets and liabilities of Bradford & Bingley, including the implications of any actions of the administrator with regard to the assets and liabilities.

6.25. The most significant assets on Bradford & Bingley's balance sheet as at 29 September 2008 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 the 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 (all described in the Appendix). I have, therefore, considered the impact of administration on these secured funding arrangements.

Timeframe of administration

6.26. The objectives of the administrator (set out at paragraph 6.18 above) are to perform his duties in the interests of creditors as a whole including holders of rights associated with dated subordinated notes. I consider that the administrator would have adopted a run-off strategy, similar to that pursued by Bradford & Bingley in public ownership. I believe that an administrator would run-off the mortgage book over a period of between five and ten years. In my administration scenario I assume a ten year period which I consider would allow an administrator sufficient time to maximise value.

6.27. I have assumed that regular distributions to the ordinary unsecured creditors would be made over the course of this administration period.

6.28. No payment of interest or principal would be made to holders of rights associated with dated subordinated notes until a final distribution date. Based on my assumption of a ten year administration period, this distribution date would be in 2018.

Prospects in administration

6.29. I have used the business plan as a basis for my assessment of the prospects of holders of rights associated with dated subordinated notes. In my administration scenario (as described in paragraphs 5.11 and 5.12 above) I consider the factors that would lead to differences in administration distributions and distributions from public ownership. The most important factor is the impact of interest which I discuss in paragraphs 6.32 to 6.37 below. The other important factors are set out in Figure 5 below. Further details of these other factors are included in the Appendix.

Figure 5: Factors leading to differences in administration distributions and distributions from public ownership

Factors that increase administration distributions relative to distributions from public ownership	Factors that increase distributions from public ownership relative to administration distributions
- No payment of state guarantee fees.	- No immediate withdrawal of SLS.
- No payment of corporation tax.	- No termination of repo agreements.
	- No immediate close out of the Barclays Warehouse.
	- Derivative counterparties would not close positions under adverse terms.
	- No additional claim from the trustees of Bradford & Bingley's defined benefit pension fund.
	- Tax assets retain value.
	- Successful sale of the deposit book and branch network to Abbey.
	- No administrator's fees.

6.30. The benefits of administration over public ownership are limited. Certain expenses are incurred under public ownership that would not have been incurred in administration, in particular state guarantee fees and the payment of corporation tax.

6.31. Administration would lead to a significant reduction in the net assets of Bradford & Bingley. Soon after an administration order was granted, I consider that counterparties to a number of secured funding arrangements would be entitled to and would take action to close out such arrangements.

Interest

6.32. The most important factor affecting the relative distributions under public ownership and administration is the interest-free Statutory Debt of £18.4 billion. In administration, post-administration interest would have accrued on this liability at the greater of the applicable statutory rate (8% per annum) and the rate applicable to the debts (i.e. the deposits) apart from the administration. This would have significantly reduced the share of the surplus at the end of the administration that would have been available to holders of rights associated with dated subordinated notes.

6.33. As discussed in paragraph 6.21 above, no interest would be payable to creditors for any period after the company entered administration except if there is a surplus after, among other things, all proven debt (including dated subordinated notes) has been repaid.

6.34. If Bradford & Bingley retains interest earning assets during the course of the administration, the cash available for distribution to creditors at the end of the administration increases as profits build through the accumulation of interest income. On the other hand, if Bradford & Bingley disposes of interest earning assets early in the administration, it could use the proceeds of disposal to make interim distributions to reduce the outstanding debts proved in the administration. Making such distributions to unsecured creditors has the effect of reducing the post-administration interest accruing in respect of unsecured creditors. Holders of rights associated with dated subordinated notes are only entitled to a payment after all proven debt of unsecured ordinary creditors is paid (as listed in paragraph 6.20 above). Post-administration interest accrues on dated subordinated notes, regardless of any distributions paid to unsecured creditors. A reduction in the post-administration interest accrued by unsecured creditors would, therefore, increase the share of any surplus that holders of rights associated with dated subordinated notes would receive.

6.35. To determine the surplus that would be available to pay post-administration interest, I have estimated the impact of interest related factors in addition to the factors set out in Figure 5 above. These include the interest expense of the working capital facility that has been provided by HMT during public ownership (this would not be an expense in an administration) and interest income from debt securities that I have assumed would be disposed of early in the administration (this income would not be earned in administration).

6.36. In administration, all creditors (other than holders of perpetual subordinated bonds and undated subordinated notes) rank pari passu for post-administration interest. Consequently, although holders of rights associated with dated subordinated notes rank alongside other creditors for the payment of post-administration interest, they are significantly diluted by the claims of other creditors. In contrast, under public ownership, I expect all unsecured ordinary creditors to be paid on an ongoing basis during run-off and, as such, the only creditors with an accrued claim in 2018 would be the holders of rights associated with dated subordinated notes, the holders of perpetual bonds and the undated subordinated noteholders.

6.37. I have assessed the impact of the dilution resulting from the claims of other creditors by developing a model of the cash flows that would arise through my administration scenario. I have concluded that, taking account of this dilution, the administration distributions for each series of dated subordinated notes would be lower than the distributions from public ownership.

Risks associated with my administration scenario

6.38. I have based the assessment above on my administration scenario but I have also considered other possible scenarios and have concluded that the outcome for the holders of rights associated with dated subordinated notes could be materially worse than under my administration scenario.

6.39. Particular risks include:

- less favourable terms through the withdrawal of the SLS;
- less favourable terms in the termination of the Barclays Senior Facility, repo agreements and derivative contracts;
- adverse mortgagee behaviour resulting from Bradford & Bingley being in administration (something I have not factored in to my favourable administration scenario analysis); and
- a requirement to pay corporation tax due to an expectation that no post-administration interest would be paid and therefore no accrual of the interest expense (a tax deductable expense) would be made. This would result in taxable profits and a corresponding requirement to pay corporation tax.

Present value of distributions

6.40. As outlined in section 5, my assessment of any loss in economic value is based on a comparison between the present value of distributions from public ownership and the present value of administration distributions. I conclude in paragraph 6.37 above that the administration distributions would be lower than the distributions from public ownership. As I have adopted an expected distribution timeframe of ten years in both cases, it would only be possible to derive a higher present value of administration distributions if I applied a lower discount rate to the administration distributions than the distributions from public ownership. Given my administration scenario adopts favourable assumptions and therefore has significant downside risk, I do not consider it would be appropriate to apply a lower discount rate.

7. My assessment of compensation

7.1. I consider that compensation would only be just if the extinguishment of rights caused a loss of economic value.

7.2. I conclude that there has been no loss of economic value because I have determined that the present value of distributions from public ownership is greater than the present value of administration distributions in respect of all dated subordinated notes. Therefore, it is my assessment that no compensation is payable by HMT under the Scheme to holders of rights associated with dated subordinated notes.

Appendix

Other important factors leading to differences in administration distributions and distributions from public ownership

Factors that increase administration distributions relative to distributions from public ownership	Factors that increase distributions from public ownership relative to administration distributions
- No payment of state guarantee fees.	- No immediate withdrawal of SLS.
- No payment of corporation tax.	- No termination of repo agreements.
	- No immediate close out of the Barclays Warehouse.
	- Derivative counterparties would not close positions under adverse terms.
	- No additional claim from the trustees of Bradford & Bingley's defined benefit pension fund.
	- Tax assets retain value.
	- Successful sale of the deposit book and branch network to Abbey.
	- No administrator's fees.

Factors that increase administration distributions relative to distributions from public ownership

Summary

Under administration certain expenses would not have been incurred that are incurred under public ownership.

State guarantee fees

A.1. In public ownership, Bradford & Bingley pays a fee to HMT for the provision of guarantee arrangements to safeguard certain wholesale borrowings and derivative transactions of, and wholesale deposits with, Bradford & Bingley existing on 28 September 2008. In administration, these guarantee arrangements would not exist and the associated fee of £0.8 billion would not be incurred.

Corporation tax

A.2. The business plan forecasts include an estimate of the corporation tax expected to be paid in each period, which amounts to approximately £2.1 billion in the ten year period. In my administration scenario, I expect that there would be a surplus available after the administrator had paid all debts proved in the administration. This surplus would be applied in paying post-administration interest and therefore the interest expense would accrue during the course of the administration. This accrual eliminates any taxable profits and therefore the requirement to pay corporation tax.

Factors that increase distributions from public ownership relative to administration distributions

Summary

An administration impacts the cash available for distribution to creditors, including holders of rights associated with dated subordinated notes, primarily through the actions of the administrator and through triggering an event of default in secured funding arrangements.

Withdrawal of SLS funding and the opening administration balance sheet

Summary: I have determined that the withdrawal of SLS funding would have resulted in a loss of approximately £0.8 billion.

A.3. 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.

A.4. 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. The Bank of England had a right to terminate the SLS funding arrangements on short notice.

A.5. 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.

A.6. 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.

A.7. 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 A.12 below.

A.8. 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.

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.

A.9. Of the £8.5 billion debt securities on the balance sheet, £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.

A.10. 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.

A.11. 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.

A.12. 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.

A.13. 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 6: 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.

A.14. 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.

A.15. 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 it would have been possible to dispose of 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.

A.16. 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 bonds.

A.17. 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 would, therefore, not have suffered any initial losses as a result of administration.

A.18. 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.

A.19. On 2 July 2010 Bradford & Bingley announced it has fully purchased and cancelled the series 18 covered bonds. Series 18 covered bonds were held by Bradford & Bingley and therefore I do not consider that this has any impact on my analysis.

Aire Valley Master Trust

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

A.20. 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.

A.21. 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.

A.22. 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.

A.23. 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.

A.24. 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.

A.25. 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.

A.26. 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.

A.27. 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.

A.28. 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[21]. In order to complete the transaction, the FSCS and HMT agreed to fund the transaction. Drawing on a facility from HMT, FSCS paid 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.

A.29. 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.

A.30. 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.

Administrator's fees

Summary: The expenses of an administrator rank ahead of all other creditor claims and I estimate the total cost over the ten year period would be approximately £0.2 billion.

A.31. The administrator would incur significant cost in managing the administration process and realising or running-off the assets. The expenses of the administrator rank ahead of all creditor claims and therefore impact the distributions available to creditors. I estimate the cost of the administration over ten years would be approximately £0.2 billion.

---

[21] Bradford & Bingley audited financial statements 2008