

**Independent Valuation  
under the Northern Rock plc Compensation  
Scheme Order 2008**

Introduction and Executive Summary  
December 2009

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by Andrew Caldwell

Independent Valuer appointed under Part 3 of the Northern Rock plc  
Compensation Scheme Order 2008

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## 1. Introduction

- 1.1. I was appointed by HM Treasury (“the Treasury”) on 8 September 2008 as Independent Valuer under the Northern Rock plc Compensation Scheme Order 2008 (“Compensation Order”).
- 1.2. My terms of appointment are set out in Exhibit A to this consultation document.
- 1.3. It is my role to determine the amount of any compensation payable by the Treasury to persons affected by the transfer of Northern Rock plc (“Northern Rock”) into temporary public ownership (“TPO”) on 22 February 2008.
- 1.4. The transfer into TPO was effected by the Northern Rock plc Transfer Order 2008 (“Transfer Order”), which was made under the Banking (Special Provisions) Act 2008 (“the Act”). The following categories of persons will have been affected by the Transfer Order:
  - those who held ordinary, foundation or preference shares in Northern Rock;
  - those whose rights to receive shares in Northern Rock (whether by subscription, conversion or otherwise) were extinguished by Article 4 of the Transfer Order; and
  - those whose “consequential rights” were extinguished by Article 12 of the Transfer Order. I explain what this means in paragraph 6.6.
- 1.5. In this document, all of the persons referred to in the paragraph above are called “Affected Parties”.
- 1.6. I am required to determine the value of shares, and the value of any right to receive shares that was extinguished by virtue of Article 4 of the Transfer Order, immediately prior to the transfer of Northern Rock into TPO on 22 February 2008. For the purposes of this consultation document, I refer to this point in time as the “Valuation Date”.
- 1.7. The Compensation Order provides a different basis for assessing compensation for those whose “consequential rights” were extinguished by Article 12. It provides that I must determine the amount of compensation that is just in respect of that person's consequential rights, taking into account any diminution in the value of property and any increase in the burden of any liability and compensation shall only be payable if it is required to be paid to comply with the Convention rights under the Human Rights Act 1998.
- 1.8. As set out in paragraph 6.12, I have not received any claims for compensation by anyone who could show that they had been affected by Article 12 and it has therefore not been necessary for me to assess any entitlement to compensation in respect of Article 12. Therefore, in this document any reference to determining whether any compensation is payable to Affected Parties should be read as a reference to

determining whether any compensation is payable to former shareholders and those whose rights to receive shares were extinguished by Article 4.

### **Purpose of this document**

1.9. This document is a consultation document which, as I explained in my letter of 13 November 2008<sup>1</sup> (“my Letter”), provides:

- a description of the information that I obtained during my valuation process;
- the approach, that subject to considering consultation responses, I propose to take to determine the amount of any compensation payable by the Treasury;
- my provisional views on the amount of any compensation payable, based on that approach and on all the material that I have reviewed and considered; and
- an explanation of the information that I consider can properly be disclosed to Affected Parties, having

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<sup>1</sup> On 13 November 2008, I wrote to those Affected Parties identified by Capita Registrars, Northern Rock’s registrars and Northern Rock. My Letter can be found on my website [www.northernrockvaluer.org.uk](http://www.northernrockvaluer.org.uk) and in Exhibit B to this document.

regard to the amendment to the Compensation Order<sup>2</sup> that was made after I was appointed, (the information which I consider can be disclosed is either set out in the text of this consultation document or in its exhibits and appendices).

1.10. I have tried to make this consultation document as clear as possible, although given the subject matter of the valuation it has been necessary to refer to some technical banking concepts and financial terms. I have explained some of the banking concepts in the text and I have included a glossary of financial terms in this consultation document.

### **Consultation process**

1.11. I invite written representations on this consultation document by 29 January 2010.

1.12. This consultation document is intended for Affected Parties as defined in paragraph 1.4 above. However, this is an open consultation process and I shall consider all written representations that I receive.

1.13. I welcome written representations on any of the points raised in this consultation document. However, I would in particular invite representations on the following issues:

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<sup>2</sup> The Northern Rock plc Compensation Scheme (Amendment) Order 2009 - [http://www.opsi.gov.uk/si/si2009/draft/pdf/ukdsi\\_9780111474655\\_en.pdf](http://www.opsi.gov.uk/si/si2009/draft/pdf/ukdsi_9780111474655_en.pdf)

- whether, given the Valuation Assumptions (defined in paragraphs 4.2 to 4.4) that I am required by law to apply, you consider that the net asset method described in Section 8 is the most appropriate valuation method; if not, please explain what other valuation method you consider to be preferable and why;
- whether it is appropriate to apply a discount to the book value of Northern Rock's assets when assessing the assets on Northern Rock's balance sheet that would have to be realised to give effect to the assumption that all financial assistance provided by the Bank of England ("the BoE") or the Treasury has been withdrawn;
- the level of discount that I propose to apply to the book value of Northern Rock's assets:
  - when assessing the assets on Northern Rock's balance sheet that would have to be realised to give effect to the assumption that all financial assistance provided by the BoE or the Treasury has been withdrawn; and
  - when assessing the amount for which Northern Rock's remaining assets could be realised;
- whether you are aware of any other evidence not referred to in this consultation document that you consider relevant to assessing the market value of Northern Rock's assets and liabilities at the Valuation

Date or which otherwise might be relevant to the amount of any compensation payable by the Treasury; in which event please identify that evidence and from whom it can be obtained; and

- whether there are any other persons whom you consider I should interview; in which case please explain why you consider such persons may have relevant evidence/information.

1.14. As I explain in Section 4 of this consultation document, the assumptions I am required to apply under Section 5(4) of the Act and paragraph 6 of the Schedule to the Compensation Order are matters which are fixed by law and are not matters on which I seek representations.

1.15. You can submit your written representations to me:

- by post to Andrew Caldwell, Northern Rock Valuer, BDO LLP, 55 Baker Street, London, W1U 7EU; or
- by email to [northern.rock@bdo.co.uk](mailto:northern.rock@bdo.co.uk).

1.16. If any further matters arise during the consultation period which are relevant to the matters addressed in this consultation document, they will be published on my website, [www.northernrockvaluer.org.uk](http://www.northernrockvaluer.org.uk). I suggest that you check my website from time to time accordingly.

- 1.17. I shall consider all written representations made in response to this consultation document which I receive by 29 January 2010. However, it is not practical for me to respond directly to every person or organisation making a submission to me.
- 1.18. Once I have finalised my independent valuation, I shall determine the amount of any compensation payable by the Treasury to Affected Parties and I shall issue assessment notices to Affected Parties which set out the amount of any compensation determined by me as being payable by the Treasury and the reasons for my decision.

#### **Shareholder register**

- 1.19. Northern Rock's registrars, Capita Registrars ("Capita"), maintain the database of names and addresses that I use for my mailings. It is therefore important that Affected Parties continue to update Capita about any change in their personal details at:

Capita Registrars  
Northern House  
Woodsome Park  
Fenay Bridge  
Huddersfield  
HD8 0LA  
Telephone: 0871 664 0340  
Fax: 0871 664 0350  
E-mail: [northernrock@capitaregistrars.com](mailto:northernrock@capitaregistrars.com)

#### **Presentation of numbers**

- 1.20. The financial numbers presented in the report are either expressed in £ billion (rounded to two decimal places) or £million unless otherwise stated and immaterial rounding differences may occur.

## 2. Executive Summary

2.1. This is an executive summary of the contents of this consultation document. A more detailed explanation of terms, expressions and assumptions used to reach my provisional views is contained in the following sections of this document, including the appendix.

### My role

2.2. My role is to determine the amount of any compensation payable by the Treasury to Affected Parties by the transfer of Northern Rock into TPO at the beginning of 22 February 2008.

2.3. As set out in paragraph 1.4, the following categories of persons are Affected Parties:

- those who held ordinary, foundation or preference shares in Northern Rock;
- those whose rights to receive shares in Northern Rock (whether by subscription, conversion or otherwise) were extinguished by Article 4 of the Transfer Order; and
- those whose “consequential rights” were extinguished by Article 12 of the Transfer Order.

2.4. I am required to assess the amount of any compensation payable to Affected Parties based on the value of their shares

or rights (as the case may be) immediately before the transfer of Northern Rock into TPO at the beginning of 22 February 2008. As set out in paragraph 1.6 above, for the purposes of this consultation document, I refer to this point in time as the “Valuation Date”.

2.5. As set out in paragraph 6.12, I have not received any claims for compensation by anyone who could show that they had been affected by Article 12 and it has therefore not been necessary, to date, for me to assess any entitlement to compensation in respect of Article 12.

### Valuation Assumptions

2.6. In my determination of the amount of any compensation payable, I am required to assume that as at the Valuation Date:

- all financial assistance provided by the BoE or the Treasury to Northern Rock 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 BoE or the Treasury to Northern Rock (apart from ordinary market assistance offered by the BoE subject to its usual terms).

2.7. I am also required to assume that Northern Rock:

- is unable to continue as a going concern; and
- is in administration.

2.8. Financial assistance as described in paragraph 2.6 is defined in Section 15 of the Act and includes loans and guarantees provided by the BoE or the Treasury. Prior to the Valuation Date, the BoE had provided financial assistance in the form of loan facilities to Northern Rock of over £25 billion. In addition, the Treasury had provided a number of guarantees, primarily to cover Northern Rock's retail products and certain wholesale liabilities.

### **Background to Northern Rock and its difficulties**

2.9. Northern Rock provided and continues to provide funds for residential mortgage lending, other personal finance and commercial secured lending.

2.10. The principal means by which Northern Rock obtained funding for the provision of mortgage loans was by raising funds in the wholesale funding markets, by issuing bonds (in a variety of forms) and by the sale of mortgage loans to investors, usually done through a process called securitisation.

2.11. Wholesale fundraising activities, including very short term unsecured funding, enabled Northern Rock to raise funds for long term lending to its mortgage customers. As one source of such funding was repaid, it was necessary for Northern Rock to obtain further sources of funding on a rolling basis.

2.12. However, August 2007 saw the start of a period of prolonged turbulence in the world's financial markets, which had already started reacting to market fears over exposure to American sub-prime mortgages.

2.13. The principal problem faced by the markets was a lack of liquidity. This was due to a collapse in confidence which resulted in financial institutions being unwilling to lend to each other. This created severe liquidity problems for Northern Rock, in particular, as its business model was heavily reliant on raising funds in the wholesale markets to fund its business.

2.14. Northern Rock therefore approached the BoE as lender of last resort ("LOLR") for a liquidity facility pending a longer term resolution of its difficulties. This approach was revealed by the BBC on 13 September 2007, following which there was a run on the bank during which retail depositors withdrew about £4.60 billion (approximately 20%) of Northern Rock's retail deposits over the ensuing four days (Friday 14 September 2007 – Monday 17 September 2007).

2.15. On 17 September 2007, the Treasury announced that it would guarantee all deposits in Northern Rock existing on that date.

2.16. These guarantees were explained and extended on 20 and 21 September 2007 and further amended on 9 October 2007, 11 October 2007 and 18 December 2007 and ultimately covered all unsecured retail products, all uncollateralised and unsubordinated wholesale products and wholesale borrowings, all payment obligations under uncollateralised derivative transactions and (to a limited extent) all collateralised derivatives and collateralised wholesale borrowings (including covered bonds).

2.17. In October 2007, further financial assistance was made available by the BoE to Northern Rock including loans secured against all of Northern Rock's assets.

2.18. Attempts were subsequently made to seek a private sector buyer for the whole business but no satisfactory terms could be agreed and, on 17 February 2008, the Government concluded that Northern Rock should be taken into a period of TPO.

### **Valuation Process**

2.19. Before forming any provisional views on an appropriate valuation method:

- I identified Affected Parties. I obtained information from Northern Rock and Capita and posted public notices;
- I considered representations from Affected Parties. I received a substantial number of written and oral representations from Affected Parties about my approach to the valuation, each of which has been considered; and
- I interviewed and gathered information from relevant parties. I requested and obtained a wide range of information from a number of parties.

2.20. This consultation document has taken some six to nine months longer to complete than I had anticipated when I was appointed. This has been due to the difficulties which I

encountered gathering information that I believe to be relevant to the valuation.

2.21. I had understood from paragraph 8 of my terms of appointment that relevant information would be readily available; however, concerns over confidentiality, in particular, were cited and certain information was not made available to me for some considerable time after I was appointed.

2.22. I discussed with the Treasury the need to pass legislation to give me powers sufficient to enable me to compel the production of information. The Northern Rock plc Compensation Scheme Order 2008 was amended in late March 2009 to enable me to apply to compel people to provide me with information.

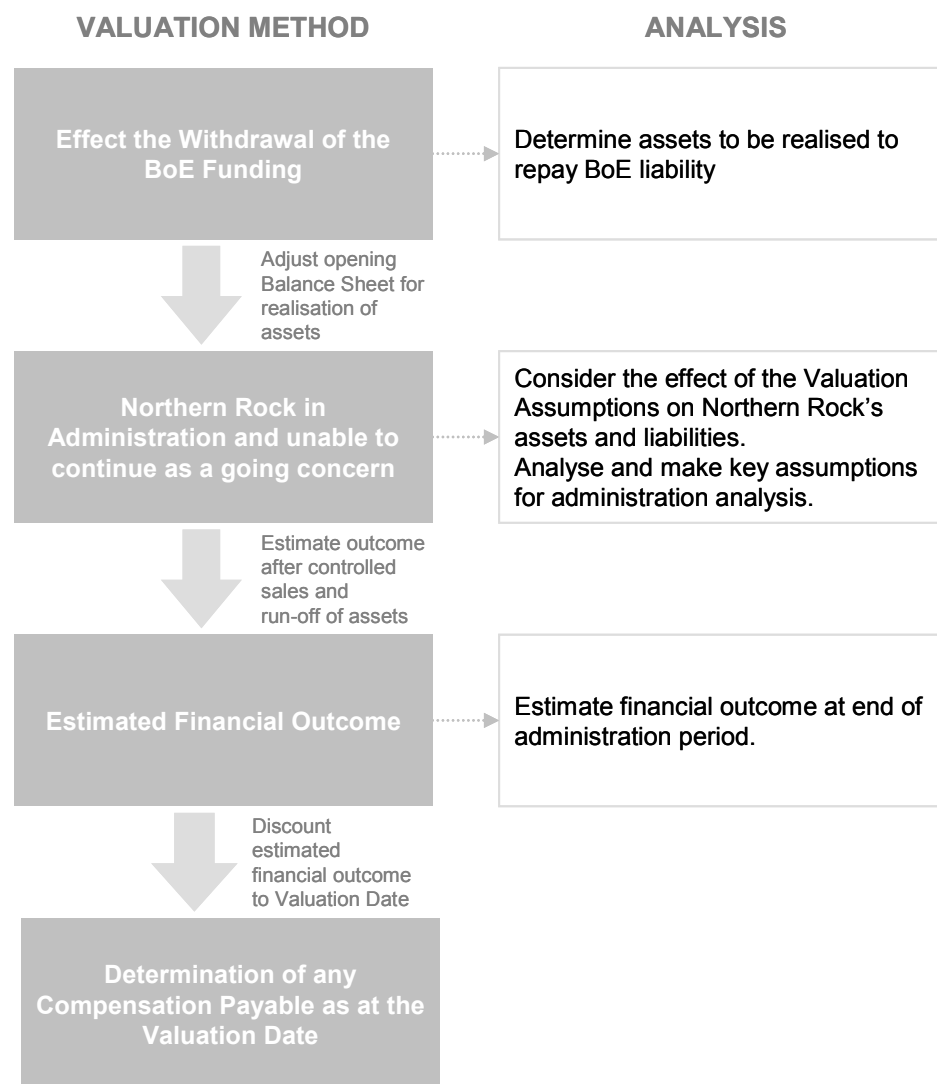
2.23. From this point onwards, access to relevant information was somewhat easier, although not wholly so. Information which I needed to finalise the consultation document took far longer to be produced than I wished and some of the information I needed to finalise was not made available until November 2009.

2.24. These problems with obtaining documentation significantly delayed the progress of the valuation, particularly in the six months or so following my appointment, but also until recently.

### Valuation Method

- 2.25. I am now proposing a valuation method on the basis of the Valuation Assumptions and all the information I have obtained.
- 2.26. The Valuation Assumptions require me to assume that all financial assistance provided by the Treasury or the BoE has been withdrawn and that no financial assistance from the Treasury or the BoE would be provided in future (apart from ordinary market assistance). This requires me to assume that, as at the Valuation Date, Northern Rock no longer has any financial assistance from the Treasury or the BoE.
- 2.27. The market share price before Northern Rock was transferred into TPO and the various offers made for Northern Rock cannot be considered as providing directly comparable benchmarks for the purpose of this valuation as they reflect continuing financial assistance from the BoE and the Treasury and the fact that Northern Rock was, at that time, a going concern.
- 2.28. On this basis my proposed method of determining the amount of any compensation payable to Affected Parties is as follows:
- (a) determine the assets that would need to be realised immediately prior to the Valuation Date to raise sufficient funds to repay the BoE funding;
  - (b) on the basis that Northern Rock is unable to continue as a going concern and is in administration as at the Valuation Date, ascertain the amount of any surplus that would have been available for distribution to shareholders; and
  - (c) determine amount of any compensation payable to Affected Parties.
- 2.29. Figure 1 below is a simplified overview of the stages of my proposed valuation method and the analysis I have carried out.

Figure 1. Valuation Method



The withdrawal of BoE Funding

2.30. I propose to proceed on the basis that the withdrawal of the BoE funding is achieved by the realisation of assets immediately prior to the Valuation Date, i.e. outside the scope of the assumed administration. It is clear that in the context of the Valuation Assumptions there is likely to have been a marked discount to the book value of the majority of those assets on any realisation. This is because of the:

- requirement for immediate realisation;
- likelihood that there would be a limited number of buyers (with lack of available funding) and no ready market; and
- perception of a distressed sale.

2.31. However, for assets that are liquid (meaning easily converted to cash) and publicly traded, I believe no discount would be applicable.

2.32. My provisional view is based on the realisation of the best possible combination of assets which in my view would take the form of:

- realisation of liquid assets (cash and Gilts); and
- realisation of certain residential mortgage loans.

2.33. For the purposes of my valuation, I propose to assume that the average discount applicable on the realisation (for example, by way of sale) of residential mortgage loans is 15%. This is, in my present view, the minimum discount that would need to be applied to secure the realisation of assets to raise the funds necessary to effect the immediate withdrawal of the BoE funding. No discount, however, is necessary on the cash or the Gilts.

2.34. I understand that Northern Rock considered that approximately £10 billion of residential mortgage loans were high quality (meaning low average LTV ratios and a low level of arrears and defaults), performing residential mortgage loans which may have attracted a lower discount than 15% to the book value. However, the discounts to book value for other residential mortgage loans were likely to be significantly higher. I have therefore applied the same average discount of 15% to all residential mortgage loans that would need to be realised to repay the BoE liability of approximately £25.38 billion.

*Northern Rock is unable to continue as a going concern and is in administration*

2.35. Having dealt with the withdrawal of financial assistance, I must consider what would happen in the assumed administration of Northern Rock. Administration is a formal insolvency procedure for companies that are, or are likely to become, insolvent, and which may allow such companies to be rescued.

2.36. On administration, an administrator is appointed to manage a company's affairs, business and property for the benefit of the company's creditors. The administrator's primary objective is to either rescue the company as a going concern or seek and adopt an approach to the realisation of assets that is in the best interests of all creditors and would achieve 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).

2.37. As I am required to assume that Northern Rock is unable to continue as a going concern, an administrator would have to consider the following alternate strategies in order to achieve the best outcome for all creditors:

- the realisation of Northern Rock's assets and settlement of its liabilities, as at the Valuation Date or shortly thereafter; or
- trading the business for a period whilst seeking to sell off the business and/ or its assets ("run -off").

2.38. Given the market conditions at the time and the likelihood of a significant discount resulting from the composite realisation of assets, I believe the administrator would continue to trade the business for a period, funded by partial realisations of assets and cashflows from mortgage loans.

2.39. I have analysed the outcome on the basis of a controlled run-off of the assets over a period of five years. This is not necessarily the end-point of an administration (as it could potentially last more than five years) but I believe that a five year period is an appropriate basis under which an outcome can be estimated.

2.40. I have considered the effect of a reduction in Northern Rock's credit rating resulting from the Valuation Assumptions and the contractual effect of those Valuation Assumptions on Northern Rock's rights and liabilities under its various loan agreements.

2.41. I have reviewed Northern Rock's liabilities and, in particular, its debt instruments and its liabilities under the Granite securitisation and the covered bond programme to examine whether the Valuation Assumptions would give rise to:

- an automatic acceleration of repayment of the liabilities or any other changes in the payment structure of the liabilities;
- any right for debt instrument holders to enforce against certain assets of Northern Rock; or
- any default interest provisions being triggered.

2.42. There is a specified order of priority in which the realisation of assets are paid to creditors and shareholders.

2.43. Proceeds from the sale of assets subject to a fixed charge security interest are first paid to the secured creditors to

whom such security is granted. Any surplus from the sale of those assets and the company's other assets is then available to the administrator to discharge amounts owed to other creditors, after payment of the costs and expenses of the administration, in the following order:


- (i) Preferential creditors; then
- (ii) Distribution of a proportion of the realisation proceeds from assets subject to a floating charge up to a maximum of £600,000 to unsecured creditors; then
- (iii) Floating charge security holders; then
- (iv) Unsecured creditors; then
- (v) Interest on all debts; then
- (vi) Shareholders.

2.44. I have made certain further assumptions related to the performance of Northern Rock's assets in a run-off. The key assumptions relate to:

- interest income;
- mortgage redemptions;
- loan loss provisions; and
- other assets in run-off.

- 2.45. Some of the assumptions I have adopted in arriving at the outcome from an administration of Northern Rock under the Valuation Assumptions may be considered to take an optimistic view of the performance of Northern Rock's assets during a run-off period, but they are within the range that I would consider to be reasonable.
- 2.46. Figure 2 is a financial outcome statement reached on the basis of the assumptions explained above.
- 2.47. The first column shows Northern Rock's balance sheet as at February 2008. The fourth column shows the balance sheet adjusted for the withdrawal of all financial assistance and the realisation of assets in order to repay the BoE. The final column shows the resulting net book value of assets and liabilities taking account of the total receipts and payments over an assumed five-year administration run-off period.

Figure 2. Estimated financial outcome statement

£ million unless otherwise stated	Actual balance sheet Feb 08	BoE withdrawal	Other adjustments	Adjusted actual balance sheet Feb 08		Forecast Dec 13
<b>Assets</b>						
Deposit with BoE	55	-	-	55		55
Cash pooling account	727	(727)	-	-		-
Treasury Investments	8,070	(1,596)	-	6,474		2,974
Structured Investments	797	-	-	797		797
SIV provision	(232)	-	-	(232)		(286)
Securitisation GIC account	173	-	-	173		173
Covered Bond GIC account	-	-	-	-		5,049
	9,590	(2,323)	-	7,267		8,763
<i>Commercial Assets</i>						
Covered Bonds	9,914	-	-	9,914	Controlled run-off and part realisation of assets  	1,730
Granite exc 07/03	41,427	-	-	41,427		5,284
Granite (07-03) <sup>1</sup>	4,922	-	-	4,922		630
Other Residential	28,034	(27,122)	-	911		201
Commercial BTL	997	-	-	997		303
Commercial	312	-	-	312		86
Personal Credit - Ventura	3,775	-	-	3,775		337
Personal Credit - MLUSL / Policy Loans	3,411	-	-	3,411		394
Provisions	(254)	-	-	(254)		(138)
Deferred Assets	415	-	-	415		19
	92,953	(27,122)	-	65,830		8,845
Tangible Fixed assets	192	-	-	192		79
Intangible Fixed assets	98	-	-	98		-
Other Assets	74	-	-	74		-
Fair value adjustments	3,409	-	-	3,409		3,409
	<b>106,315</b>	<b>(29,445)</b>	<b>-</b>	<b>76,870</b>		<b>21,095</b>
<b>Liabilities</b>						
BoE Funding	25,277	(25,277)	-	-		-
BoE PIK	100	(100)	-	-		-
Securitised Funding	40,536	-	175	40,711		4,568
Covered Bonds	9,554	-	-	9,554		5,229
Unsecured Lending	27,508	-	(175)	27,333		8,218
Unsecured Lending - interest payable	-	-	-	-		7,045
Fair value adjustments	1,712	-	-	1,712		1,712
<b>Total Liabilities</b>	<b>104,686</b>	<b>(25,377)</b>	<b>-</b>	<b>79,309</b>		<b>26,772</b>
<b>Net equity surplus / (deficit)</b>	<b>1,629</b>	<b>(4,068)</b>	<b>-</b>	<b>(2,440)</b>		<b>(5,676)</b>

2.48. The estimated financial outcome statement shows a net deficit of approximately £5.68 billion. On this basis, there would be no surplus available at the end of the assumed administration period for distribution to shareholders.

2.49. In reaching this provisional view, I have made what I consider to be optimistic assumptions with regard to both the assets that would need to be realised to repay the BoE loan and to asset performance. Failure to achieve these optimistic assumptions would increase that deficit.

2.50. I have identified a number of key financial and operational risks that would adversely affect the outcome of the assumed administration. I summarise these risks at paragraphs 16.15 to 16.34 below. However, at this stage as they do not materially affect my provisional views as to the amount of any compensation payable to Affected Parties, I have not quantified the financial consequences of these risks. If, as a result of representations made in response to this consultation document, I conclude that the extent of these risks is relevant, I would need to undertake that task at that stage.

#### *Financial Risks*

- Lower levels of mortgage redemptions and increasing provisions;
- Issues in the Granite securitisation and covered bond programme, including those related to the requirement to transfer the GIC accounts and the

consequential impact on both the Granite securitisation and the covered bond programme<sup>3</sup>; and

- Wind up of pension fund.

#### *Operational Risks*

- Problems coping with the demands for repayment of customer deposits;
- Difficulty in retaining key staff; and
- Set-off – the possibility that customers who have both mortgage loans and deposit accounts with Northern Rock will not pay their mortgage loans if they do not have access to their deposit accounts.

#### *Amount of any compensation payable*

2.51. It follows from my provisional view that there would be no value in Northern Rock's shares as at the Valuation Date and therefore that no compensation is payable to former shareholders.

<sup>3</sup> Further details of Granite and the covered bond programme are to be found in Section 7.

2.52. It also follows that there would be no value in the right to receive shares and that no compensation is payable to those whose rights to receive shares were extinguished by Article 4.

