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Subordinated Bondholders' Update (No. 3)

As you are no doubt aware, the Independent Valuer of the ordinary shares in Bradford & Bingley (B&B), Mr Peter Clokey, has declared the ordinary shares to be worthless at the date of nationalisation. This does not directly affect the subordinated bonds (formerly called PIBS). This note provides an update for B&B bondholders.

The Current Situation

The current situation for the holders of 11 7/8% and 13% bonds (the undated subordinated bonds - PIBS/PSBs) is as follows. The Government has indicated that all bondholders will be repaid both their capital and rolled up interest in the run off of B&B business after the repayment of the loans made to the bank by the Financial Services Compensation Scheme (FSCS), the Treasury and Bank of England (BoE), providing that there is enough money remaining in the business. The FSCS loan is £14 billion and the Treasury loans are £4.4 billion with a working capital facility of £8.5 billion. B&B's loan book is currently valued at just less than £38 billion.

The Independent Valuer found that no bondholders are eligible for compensation payments as they are in a better situation following nationalisation than they would otherwise have been if the bank had been put into Administration, which he considered was the alternative solution available to the bank at the time.

What has the Valuer Revealed?

The Valuer's report revealed that a hitherto undeclared loan of £5 billion from the BoE's Special Liquidity Scheme (SLS) existed at the point of nationalisation.

As one of the terms of the Compensation Order (the terms of reference for the valuation) is that all Government funding is immediately withdrawn, the Valuer has therefore concluded the company would have had to go into Administration and therefore should be valued on that basis. The result of such an Administration would be that there would be no money remaining to repay the shareholders, and hence no compensation is due to them.

The bondholders are in a more fortunate position following nationalisation as they remain creditors of the nationalised B&B, and as described above should be repaid following the run off.

The undated subordinated bonds now rank pari pasu with all other bonds, including dated bonds, remaining in B&B. The hierarchy of settlement is to be maintained in run off with bondholders being repaid in order behind the Government and FSCS loans. The undated subordinated bonds therefore rank last but before the sole shareholder (the Treasury).

Another important revelation for bondholders was made by the valuer after performing four stress tests on B&B in order to determine what money might remain available to repay bondholders. These stress tests took the form of four separate models each of which assumed a more difficult economic situation in the country over a 10 year period of run off from 2008 to 2018.

The good news for bondholders is that in each model there remained sufficient money to repay both the capital value at par (£1 per bond) and the rolled up interest. These models were built with the expertise of Price Waterhouse Coopers and are the best guide to the final outcome from the bank. However, no model can guarantee the outcome in the future since it is not possible to predict every event and bondholders should remain cautious and not place absolute trust in the results of these models. The valuer estimates that the run off could take approximately 10 years, ending in 2018/2020.

B&B remains profitable and has recently bought back nearly 80% of its debt in dated bonds at a low price using a tender offer procedure in the UK. This has improved its capital strength and made the position of the remaining bondholders safer.

Possible Future Scenarios

What are the possible future scenarios and exit routes for bondholders?

1. The bondholders remain invested in the bank and are repaid both capital (at £1 per bond) and rolled up interest at the end of the run off.

2. B&B could make a tender offer to the remaining bondholders to buy in their bonds at a reduced price and possibly without payment of any rolled up interest. Any such offer would need careful assessment using discounted cash flow to determine a "fair value". A tender offer is very attractive to B&B as these bonds, particularly the undated subordinated 11 7/8% and 13% bonds, represent a very expensive form of debt for the bank.

3. With the passage of time these bonds should gain value in the markets as the interest continues to accumulate in them at a rate which is high for the present low interest rate market. The capital and interest value contained in these bonds will be assessed by the market using a discounted cash flow calculation to find a "fair value" for them in today's market assuming repayment in 2018/2020. Bondholders may be able to sell their bonds in the market for an acceptable price in the future.

Should either of scenarios 2 or 3 arise in the future BBAG will publish its assessment of them in order to aid bondholders in determining what is the best course of action for them.

Note though that these scenarios may be affected by restructuring of B&B (for example, merger with other companies as has been suggested might take place). So it is important that we keep a close eye on future developments.

It is of course necessary to point out that there is no immediate prospect of resumption of interest payments from the subordinated bonds, although we hope payments will be resumed once the FSCS, Treasury and BoE loans are repaid.

Legal Advice Received

Charles Fussell & Co. solicitors acting for BBAG, sought counsel's opinion on a range of possible legal remedies which bondholders might pursue before the Independent Valuer produced his report. In brief the advice was:

1. Possible claims under human rights legislation or other challenges to the independent valuer's determinations. This would require an application for a judicial review, and possible subsequent claim to the EU HR court which can take several years. The costs of these actions would be very high with no certainty of success.

2. A challenge to the compensation process and/or the Valuer's findings in the Financial Services and Markets Tribunal. Counsel's recommendation was that the Undated Bondholders should await the outcome of the valuation process and seek to challenge the Independent Valuer's conclusions if necessary, both as to the exclusion of the Undated Bondholders from the compensation scheme and, if appropriate, the basis of assessment of compensation generally, in the FSMT. One big advantage of proceedings in the FSMT is that ordinarily the Tribunal will not make a costs order against the losing party, providing that the party acts reasonably. Therefore, any party bringing a challenge to the Independent Valuer's assessment notice in the FSMT is unlikely to be at risk of paying costs.

The BBAG committee has considered the implications for bondholders contained in the Valuer's report and concluded that in view of the Valuer's findings for compensation of the dated bondholders, that no compensation is due to them, there would be no reasonable possibility of obtaining a different judgement which improved the undated subordinated bondholders' situation by taking legal action in the FSMT at this time.

It is probable that the B&B ordinary shareholders will register objections to the Valuer's findings based around the definition of the SLS loan facility as "not part of the BoE's normal market activity" and the lack of transparency in B&B accounts with regard to the SLS loan.

The bondholders' representatives in BBAG will maintain a close eye on developments going forward and will report further to you when necessary, but we do not see any immediate action as being required in respect of the bondholders.

David Blundell
Chairman