A Note on the Northern Rock Legal Action by Shareholders

An application for a Judicial Review of the Nationalisation Act and the associated Compensation Order was filed on behalf of a representative sample of private shareholders on the 8th May 2008. SRM Global also filed a similar application on that date and RAB Capital subsequently filed such an application in addition (these two companies are the largest institutional shareholders). This note attempts to explain in simple terms what the legal action is based on and the arguments plus evidence that the plaintiffs have put forward in their application.

It is worth emphasising that shareholders have not demanded any specific compensation for the confiscation of their property by the Government. All they are asking for is that such compensation be determined in a fair and proper manner, using normal legal and business precedents for the valuation of companies in such circumstances. The three applications (which are similar and will be heard as one case) in essence ask that the courts declare the relevant terms of the Act and the Compensation Order to be incompatible with Human Rights legislation and that they should be quashed.

The following gives some details of the application filed by the private shareholders and is a summary of the contents of the application:

The Legal Issue

The basis of the application is that the Nationalisation Act (the "*Banking (Special Provisions) Act 2008*" to give it its full title) and the Compensation Scheme Order 2008 are incompatible with the rights guaranteed under the European Convention of Human Rights which is embodied in the Human Rights Act 1998.

Article 1 of the First Protocol to the European Convention on Human Rights provides that –

"Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by general principles of international law."

Whilst the State may expropriate assets in pursuit of a legitimate aim in the public interest, it is not entitled to do so in the absence of a reasonable relationship of proportionality between the means employed and the aim sought to be realised. This requirement of proportionality involves a "fair balance": as to the act of expropriation, in itself, and whether it is in the public interest, it must be a proportionate response balancing the general interest of the community and the protection of individual rights. Compensation terms are material to any fair balance. Thus a decision to expropriate without compensation reasonably related to the value of the property expropriated will not normally meet the demands of fair balance.

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The plaintiffs' submission is that the Act and the Compensation Order fail to meet the requirements of that balance between the interests of the community on the one hand and the claimants' rights on the other. The fair balance test is not satisfied in relation to the expropriation of the shares in Northern Rock.

The Nationalising Legislation

The Nationalisation Act and the Compensation Order enabled the Government to acquire all of the Ordinary and Preferences shares in Northern Rock on the 22nd February 2008. The legislation established that compensation would be paid by the Government to the shareholders but it hedged this around in a number of ways. Specifically:

Section 5 of the Act required that certain assumptions must be made *"in determining the amount of any compensation payable by the Treasury by virtue of any provision in an order"*. The assumptions are:

- "*that all financial assistance provided by the Bank of England or the Treasury to the deposit-taker in question [i.e. Northern Rock] 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 the Treasury to the deposit-taker in question (apart from ordinary market assistance offered by the Bank of England on its usual terms)*".

By section 9 of the Act it was further provided that an order made under section 5 could make various supplementary provisions about the assessment of the compensation, including as to "*methods of calculation, valuation dates and matters to be taken into, or left out of, account in making valuations*".

Importantly, however a subsection directed that regulations could be made which include provisions for "*the making of assumptions as to any matter*", including in relation to the relevant deposit-taker that "*it is unable to continue as a going concern" and that "it is in administration*".

On 12 March 2008 the Compensation Order was made. This required the compensation payable by the Treasury to persons who held shares in Northern Rock immediately before nationalisation to be determined in accordance with paragraph 3 of the Compensation Order. Specifically, that paragraph stipulated that "*the amount of compensation payable to a person shall be an amount equal to the value immediately before the beginning of 22 February 2008 of all shares in Northern Rock by that person*".

However, and critically, paragraph 6 required that in the determination four assumptions are to be made, namely the two required by section 5 of the Act (see above) and also:

(a) that Northern Rock "*is unable to continue as a going concern*", and
(b) that Northern Rock "*is in administration*".

Article 7 of the Compensation Order provides for the appointment of an independent valuer to value the compensation payable.

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A Key Allegation

It is suggested that the purpose of the Government in expropriating the shares in Northern Rock was so that the Government, having provided lender of last resort facilities, could enjoy in return not merely interest in respect of the facilities but also the whole of any profit to be made on a subsequent disposal of Northern Rock.

The four artificial assumptions required by the Act and the Compensation Order referred to above, taken in conjunction with a valuation time of immediately before the beginning of 22 February 2008, were calculated to ensure that no, alternatively no appreciable, compensation would be paid to those whose shares were appropriated.

In particular on the 21st January 2008 a Treasury announcement referring to a possible private sector proposal for Northern Rock stated that the proposal would "*provide the Treasury with the ability to share in the potential upside returns for private sector participants in return for the financial support being provided to*" Northern Rock; and on the 23rd January 2008 the Prime Minister stated to the House of Commons, "*It is our intention to get the best deal for taxpayers; they will get their money back, and make a profit*".

Other Relevant Points

As the FSA, the Treasury and the Bank of England have repeatedly stated, both before and after nationalisation, Northern Rock was, and remains, a solvent institution with a strong and sound loan background.

Until about 18 February 2008, when the Government announced its intention to nationalise Northern Rock and trading in the shares in Northern Rock were suspended, Northern Rock enjoyed a substantial market capitalisation.

The support made available by the Bank as "lender of last resort" was designed to overcome short-term liquidity difficulties and to enable Northern Rock to carry out its business in the normal way, in common with facilities made available by other central banks and with settled practice. In providing this support, the Bank was performing a function which it habitually performs until such time as the liquidity difficulties which Northern Rock was experiencing eased. Northern Rock was required to meet, and was meeting, its obligations under the liquidity facilities.

Both the liquidity facilities provided to Northern Rock and the guarantees provided by the Treasury in respect of deposits and payment obligations under various transactions have been provided on commercial terms.

Private sector proposals were made regarding the future operation of Northern Rock in accordance with criteria specified by and/or agreed with the Treasury. These proposals would have enabled Northern Rock to continue to operate in the private sector and the claimants would have retained an interest in Northern Rock.

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Ultimately the private sector proposals were rejected in favour of expropriation. This rejection was for the reasons stated, i.e. that that Government desired to make a profit.

As a result of the expropriation the Treasury stands to make a substantial profit – and the Claimants a certain loss - from the taking of Northern Rock into public ownership.

> Comment: The Government is arguing that no account should be taken of financial assistance offered to the company by the Government when valuing the business and therefore it should be valued as if that assistance was withdrawn. However our view is that the company (and hence indirectly the shareholders) were already paying and have paid appropriate arrangement fees on the loan facilities and fees to cover the deposit guarantees. In addition they are paying commercial interest rates, indeed possibly penal rates, on the loan facilities provided. Also the loans made by the Bank of England will be repaid, and indeed already have been partially repaid. The Government therefore seems to be asking to be paid twice over for the value of the loans provided and the relevant guarantees.
>
> Also the Government seems to believe that as one creditor of the business (among many including of course the depositors who chose not to withdraw their funds in the bank run), it has the right to all the equity in the business. It is difficult to understand on what moral principle or legal precedent they believe this is based.

The Claimants

The private shareholders named as claimants in the application are as follows, with some brief details of how they acquired their shares in Northern Rock:

Dennis Grainger

Mr Grainger worked at Northern Rock from 1998 until he retired in 2007. He took part in the company's employee Share Save schemes contributing the maximum possible deduction from his salary of £250 per month. He also took part in the Approved Profit Share scheme and the Share Incentive Plan. As a result he acquired some 7,195 shares during his employment. The loss of the value of those shares is a very significant loss for him and his family in terms of his overall assets. He put his savings into the Company's shares to provide for his retirement and that nest-egg will be lost unless some value is attached to the shares of Northern Rock.

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Doreen and Dennis Shannon

Mr Shannon worked at Northern Rock for 19 years, retiring in 2007. He took part in the Northern Rock employee share schemes and hence acquired some shares as a result between 2001 and 2005. Both Mr and Mrs Shannon held accounts with Northern Rock prior to the demutualization in 1997, plus a joint account. As a result they acquired 1,500 shares at demutualization plus a further 500 as Mr Shannon was an employee. Some of these shares were subsequently sold but in total they held 5,100 shares at the date of nationalization.

Anne Dawson

Ms Dawson acquired 500 shares as an account holder when the company was demutualised. Although those shares were subsequently sold, she inherited 1,000 shares from her mother and grandmother so she held 1,000 when the company was nationalised.

Anne and Robert Wallace

Mr & Mrs Wallace held a savings account with the company at demutualization and as a result acquired 1,500 shares. They retained those until nationalization.

Mary Warner

Mrs Warner purchased 437 shares in March 2007, paying £11.43 per shares. She considered it a sound investment at the time. She and her husband are retired and live off their savings.

Irving Struel

Mr Struel is a trustee of the W&S Executive Pension Trust which is a small company pension scheme for employees of a firm that Mr Struel ran. In August 2007 Mr Struel purchased 2000 shares at a price of £7.37 and as a result they have suffered a significant loss. He purchased the shares because he believed it was a good and secure long term investment.

Graham Rigby

Mr Rigby purchased 1,354 shares at £7.54 on the 31st August 2007. He is retired and used his savings and pension in order to invest. He thought the performance of the bank was good that this was a sound investment. It has become clear that at the time he purchased the shares the company had had long discussions with the Bank of England and the Financial Services Authority in relation to the problems that Northern Rock faced. That was not known to him or anyone outside Northern Rock, the Bank of England or the regulatory authorities until mid-September. He purchased his shares when this information was bound to have a significant effect on the share price and accordingly he describes the time at which he bought his shares as a time of a "false market". The directors of Northern Rock and the regulators had inside information which was clearly price sensitive and was going to have a significant effect on the value of Mr Rigby's investment.

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Stanley Schweitzer

Mr Schweitzer purchased 4,000 shares in September 2007 at a price of £5.80. They were purchased for his pension fund – he thought they were a sound investment and a solid UK bank. He was aware of the announcement on the 14th June of the Bank of England providing liquidity support but he believed the problems were short term and he regarded his investment as one for the long term.

Ian Stroud

Mr Stroud is retired and to increase his income and capital purchased shares in September 2007 at a price of £2.80. He regarded these as a long term investment and felt that the bank was a sound proposition notwithstanding its problems. The Government had said they were standing behind the bank and he believed that it would recover in due course with that support. Mr Stroud feels that the conduct of the Government has been utterly appalling by seeking to make a profit from the nationalization.

Adrian Shilton

Mr Shilton purchased 646 shares in October 2007 at about £3. He had an affinity for the North East of England and the fact that Northern Rock was based there was a consideration for him. He was aware of the news surrounding Northern Rock. He had no other investments and this was the first time that he had purchased shares.

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The Application and Evidence of SRM Global

The following is a brief summary of some of the evidence and arguments submitted by SRM Global Master Fund LLP, which is also relied on in the application by the private shareholders. Much of the evidence relates to the historic events at Northern Rock which are documented on the UKSA web site for those who need reminding of them. SRM held 11.5% of the ordinary shares in Northern Rock at the date of nationalization. Matters also covered in the private shareholders application have not been repeated below.

The Desire of the Government to Make a Profit

The plaintiffs point out that in the Chancellor's statement on the 17th February which announced the nationalization he said that the first of the Government's objectives, achieving financial stability, had been met by the previous decision in September 2007 to intervene and provide support to Northern Rock. The second objective (described as "safeguarding depositor's money") was said to have been achieved by the guarantee arrangements. The Chancellor confirmed that none of these had been called, and that there had therefore been no cost to the taxpayer. It was therefore clear from his statement that the existing loan and guarantee arrangements had not resulted in any cost to the taxpayer; in fact the Bank of England had profited from the loan interest paid by Northern Rock.

The Chancellor indicated that each of the private sector proposals was dependent on some form of continuing public support, and that:

"a subsidy on the scale required would not in the Government's judgment provide best value for money for the taxpayer, in circumstances where the private sector rather than the taxpayer would secure the vast majority of the value created over the period ahead."

The plaintiffs argue therefore that it is clear that the decision to proceed with nationalization was based on a desire on the part of the Government to make a profit from the future operation of Northern Rock.

The Valuation Resulting from the Act and the Compensation Order

The Act and the Compensation Order severely restrict the valuer's freedom to assess compensation, by requiring him to adopt a number of assumptions about the business and status of Northern Rock. Expert evidence prepared by SRM demonstrates that the effect of the application of the assumptions is that the value of the shares, and therefore the compensation payable to shareholders, is likely to be held by the valuer to be nil.

What the Valuation Would Be Without the Assumptions

Expert evidence provided to SRM indicates that, absent the application of the assumptions in the Act and the Compensation Order, the value of Northern Rock at the date of nationalization would be at least £3.00 per share, but in all likelihood much more.

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The Nationalisation Breaches the "Fair Balance" Test

The suggestion is that the compensation provision breaches the "fair balance" test in Article 1 of the First Protocol to the European Convention on Human Rights because the amount of compensation payable will be nil, or (at best) will be negligible. In addition the following points are made:

A – The nationalization of Northern Rock was not designed to achieve any independent legislative objective or general aim of social policy. It was a specific measure, targeted at a single bank, aimed at ensuring a profit for the Government.

B – Notwithstanding the run, and the ensuing period of uncertainty, Northern Rock was, and remains, a solvent business with a good quality loan book.

Assumptions Contrary to Fact

SRM argue that there is no proper basis for proceeding to value Northern Rock on the assumption that the liquidity support assistance provided by the Bank of England and the Treasury has been withdrawn (as stated in the Nationalisation Act). This assumption is contrary to fact. This assistance was provided, and the loan facility is still in place, as are the Treasury guarantees.

Comment: It is seems exceedingly odd to us and incompatible with the general principles followed in company valuations that the Government wishes to value the company as if its assistance had been withdrawn. Clearly it had the choice whether to provide support to the company and chose to do so on the basis that it was viable business at the time (assets exceeded liabilities and it was and is a "going concern"). It now wishes to apparently backtrack on that decision and puts forward the totally artificial proposition that such support was not provided.

Clearly any acquirer of a business would like it to be valued on assumptions that minimises what he might pay for it, but that is patently unfair and would not be allowed in any normal independent business valuation. In this case the acquirer is attempting to set artificial terms of reference that minimises what they will have to pay for it, hence maximising their profit when they subsequently come to sell it back to the private sector.

The provision of this support was as part of the "lender or last resort" function and such facilities are potentially available to all eligible banks. Northern Rock has met the penal interest rate obligations on the loans, the guarantees were not called and Northern Rock has paid the fees due in respect of the guarantees. Furthermore the loans will be repaid by the end of 2010 according to the company's business plan.

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Article 56 Issue

SRM point out that the matters raised also potentially give rise to a potential breach of Article 56 of the EC Treaty and SRM is presently raising them with the European Commission. SRM is not asking the court to address this issue at the present time but may do so in future.

SRM Evidence by Philip Price (Chief Operating Officer)

SRM is an investment fund, based in the Cayman Islands. They bought heavily into Northern Rock because they saw that after the unfortunate events which led to the run on the bank, the shares were trading at a deep discount to their true book value. SRM emphasizes that Northern Rock has always been solvent in the sense that it has a positive net book value, but has suffered from temporary illiquidity.

This illiquidity was addressed by the "lender of last resort" (LOLR) facilities granted by the Bank of England, which is the purpose of those facilities – this issue is addressed more fully in the evidence of Professor Congdon.

When Northern Rock is "privatised" at the end of the period of temporary public ownership, it can confidently be predicted that the sale of its equity will achieve a substantial price: significantly more than its current book value. This will therefore be very substantially more than the former shareholders will receive for their shares, and HM Treasury will have a substantial profit – which was, after all, one of the purposes of nationalization (probably the purpose of nationalization), as the Prime Minister acknowledged. It is not difficult to make a profit on the sale of assets which are acquired for next to nothing.

Mr Price points out that the objectives to be met by the private sector proposals for Northern Rock changed over time, and the reason why they changed was because the Government came to realize that Northern Rock was a good and valuable business. The Government took advice from Goldman Sachs and subsequently imposed a new requirement on the interested parties of an "equity upside", ie. in addition to making a return on the LOLR support, the Government was insistent that it share in the "profit" to be subsequently obtained from the recovery of the company. Doubtless it was considered that a return on equity investment made by the private sector would be politically inexpedient.

But the Government did not make an equity investment. By means of nationalisation, the Government has abrogated to itself the rewards of an equity investor in spite of being no more than a lender (and potential guarantor). Moreover it has done so without providing any compensation to the people who would otherwise have enjoyed the rewards of this equity investment – namely the former shareholders.

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The Run on the Bank and the Associated Leaks & Announcements

Mr Price covers the events of the run on Northern Rock in some depth. He notes that the BBC revealed at 8.30pm on the 13th September that Northern Rock had sought "*emergency funding*" from the Bank of England in its role as Lender of Last Resort because it feared it could "*run out of cash*". There was an immediate (and understandable) response by Northern Rock's online customers with many arranging to transfer their money out that night. The bank's web site reportedly crashed that evening. The BBC announcement was only later followed by a formal announcement on 7.00 am on the 14th September.

Mr Price notes that notwithstanding the significance of the BBC leak, the Chancellor has explained that no inquiry has been undertaken by HM Treasury. It seems he did not think it was worth pursuing.

The European Commissioner has disagreed that an announcement was required as a matter of European law, and the position is very different with the liquidity facilities which the Bank of England is now providing for the market – institutions making use of the recent £50 billion facility are to have their anonymity preserved.

The Final Decision to Nationalise

Mr Price considers that the private sector did everything which was asked to find a solution for Northern Rock going forward, including responding to changing requirements, but the process came to an abrupt end. At no time did the Government suggest that the proposals being put forward were inadequate. It would, of course, never have been possible for the private sector to deliver what the Government has now achieved: i.e. payment of the entire equity value in Northern Rock to the Government.

SRM favoured a private sector solution because this obviously retained value for shareholders. They were constructive in their approach and offered to make substantial additional investment in the business by supporting a rights issue. SRM's approach is to be contrasted with that of the speculators in Northern Rock shares, many of whom exacerbated the difficulties by short selling of the shares.

Withdrawal of LOLR Support and the Valuation Assumptions

The evidence of Mr Ashton (see later) is to the effect that the assumption of the withdrawal of LOLR support (and its future unavailability) which will lead to a nil value under the independent valuation under Compensation Order. The reality is of course that LOLR support was given, and is continuing.

There is an air of unreality concerning this and the additional assumptions laid down in the Act and the Compensation Order. The Government was always in a position to precipitate administration by withdrawal of the LOLR facilities, or to procure administration in accordance with the terms of the facilities. But it did not do so. This was because:

A – It would have caused the very systemic failure, and loss of confidence in the market, which the LOLR support was designed to avoid; and

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B – it would have been entirely unproductive in respect of Northern Rock.

The expert evidence of Mr Ashton and Mr Katz deals with the inevitable loss of value that occurs when an insolvency procedure is implemented. The arrangement with the Granite securitization vehicle would also have contributed to the difficulties.

The lack of explanation of the additional assumptions for the valuation draws one to the conclusion that these assumptions were imposed to make absolutely sure that no value is attributable to the former shareholders' shares in Northern Rock. Nationalisation has achieved a result for the Government which it would not (and could not) have achieved by means of administration; nor were there any other lawful or commercial means whereby the Government could have acquired 100% of the unimpaired equity value of Northern Rock.

In summary SRM argue that the Compensation Scheme which has been established is not fair or balanced, and that the compensation which will ensue is grossly disproportionate to the true value of the shares. In these circumstances, nationalization amounts to confiscation of shareholder value.

The Evidence of Professor Tim Congdon

Professor Tim Congdon is one of Britain's leading economic commentators. Between 1992 and 1997 he was a member of the Treasury Panel of Independent Forecasters (the so-called "wise men") which advised the Chancellor of the Exchequer on economic policy. In 1997 he was awarded the CBE for services to economic debate and he is the author of a number of books and academic papers on central banking and monetary policy.

His evidence (which runs to 46 pages in full) can be summarized as follows – this is taken from his "executive summary":

An accepted function of central banks – including the Bank of England – is to provide LOLR loans to solvent banks which are having difficulty funding their assets (i.e. banks which are "illiquid").

In the summer of 2007 Northern Rock had complied with all the requirements of its official regulator, and had positive shareholders' funds of about £2 billion after many years of consistent profitability. It was therefore both a bank which could reasonably expect to receive LOLR assistance from the Bank of England, and a bank which was solvent, as that term is understood in the banking business.

Northern Rock became "illiquid" in September 2007, with its liquidity seriously exacerbated by a run on its deposits. It duly received LOLR assistance (as one would have expected in respect of a solvent institution facing such circumstances).

The practice and custom of all industrial countries is that the central bank extends a LOLR loan at a penal rate to an illiquid but solvent bank. Past precedents – from the UK as well as around the world – show that it is a paramount objective to ensure that depositors should be repaid in full.

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Nationalisation may occur when shareholders' equity is negative, so that the bank cannot – from its own resources – repay depositors fully.

A statement of principles about the conduct of LOLR operations by Mr Edward George (now Lord George), the then Governor of the Bank of England, was made in November 1993. Although insisting that LOLR assistance was intended to penalise institutions seeking LOLR support, it was also said that the purpose of such assistance was *not* to endanger their existence (i.e. *not* to bankrupt them). Implicitly, their survival as privately-owned companies once the loan had been repaid was also envisaged.

The suggestion that the government should seek "a return" or "an adequate return" on "its money" in circumstances of LOLR, or should somehow make a profit or achieve "value" (beyond the repayment of LOLR assistance in accordance with its terms), is unprecedented in my experience. It seems to arise from a misunderstanding of the nature of LOLR assistance, and specifically, from a confusion between a loan and a capital injection.

The Evidence of David Ashton in relation to the Valuation

David Ashton is a Director of LECG and both a Fellow of the Academy of Experts and a Fellow of the Chartered Institute of Arbitrators. Over the last 25 years he has advised on over 150 cases including many expert determinations of business values. His evidence also relied on that of Tim Congdon and a witness statement provided by Alan Katz, a Chartered Accountant with over twenty years experience as an insolvency practitioner. Mr Ashton's evidence consists of 29 pages of which this is a brief summary:

In response to questions posed by SRM, Mr Ashton first outlined the general principles followed in business valuations. He explained how there will typically be a range of values that a valuer could produce because of the forward looking nature of any valuation, the uncertainty of future cash flows, and the fact that different valuers may have different expectations about the future prospects of a particular investment. Also certain owners may be able to realize greater value from an asset than others.

There are also a number of different valuation methods. For example, future return based methods (e.g. discounted cash flows, DCF), market based methods (to comparable market benchmarks) and asset based valuations being the main three approaches. However the last is generally less useful except where the business value is principally based on physical resources or monetary assets.

A variety of valuation methods will usually be used, with the weight attached to each being dependent on the judgment of the valuer. This helps to produce a more rigorous calculation of value.

If the business is not expected to continue as a going concern, then an asset based method of valuation may be the only appropriate method. If the business is expected to continue in future, then a method which takes into account future returns is likely to be more appropriate.

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Mr Ashton suggests that in the case of a bank which is expected to operate as a going concern, if sufficient information were available, a DCF method would be an important part of any valuation exercise. Forecasts would of course need to be prepared to establish the future profits and cash flows. Where a range of different scenarios were possible, then these might be combined by weighting them to produce an "expected" outcome.

The Approach to Valuing Northern Rock

Understanding the position and prospects of the business is a critical first step in any valuation process. One of the critical aspects in the case of Northern Rock is the issue of whether it was likely to continue to receive financial assistance from the Bank of England and the Treasury, and hence whether it was expected to continue as a going concern.

Mr Ashton notes that the statutory accounts of Northern Rock for the year ending December 2007 were prepared on a going concern basis and were given an unqualified audit report by PriceWaterhouseCoopers. However it was noted in the Auditors' Report that the validity of the going concern assumption was dependent on continuation of support and it was assumed that this would continue.

Professor Congdon's evidence suggests that support would have continued for as long as reasonably necessary to allow Northern Rock to see out its short term liquidity issues. And such support has indeed taken place.

If the assumption of continued support is made, then a valuation on a going concern basis would be the most appropriate.

A Range of Valuations Based on Limited Information

Mr Ashton points out that the necessary information on the future prospects was not available, and he had also limited time in which to prepare his report. However he did consider a number of valuation reference points and drew conclusions from these as to an indicative range of values for Northern Rock at the valuation date.

Reference points considered were the quoted share price (90p immediately before nationalization), asset-based values, the value attachable to proposals for private sector funding and analysts' estimates of the value prior to nationalisation (although some of these were based on expectations of or the risk of nationalisation).

As regards the quoted share price, Mr Ashton points out that one reference point is the price prior to the run on the bank. This share price would be uncontaminated by valuations based on inappropriate assumptions about the going concern nature of the business (that price was £6.39). However the market outlook has changed since September 2007 such that UK listed banks are generally more lowly valued now – so it may be necessary to reduce that by 41% looking at comparable banks which would give a figure more like £3.80.

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As regards an asset based valuation, Mr Ashton suggests that the December 2007 accounts are a sound starting point. These show a net asset value of £3.00 per share. However to the extent that significant intangible assets existed within the business (such as expertise, its customer base, its branch network, or brand value), these would not be represented in this asset value. In general Mr Ashton would expect a business operating as a going concern to have a value higher that of its tangible and monetary assets.

An analysis of comparable "price to book value" of similar listed UK banks suggests that the value of Northern Rock could be between £2.92 and £3.53 per share on that basis. However it is pointed out that the credit crunch has severely affected the share price of banks, and these might rapidly recover so this should be taken into account.

The valuation that might have been attached to the Olivant, Virgin and in-house company proposals is discussed although there is limited information available on them. In addition public analysts' reports on these offers published at the time are limited and various in their conclusions. A number of the latter also seemed to assume that the business might not remain a going concern. Note: the discussion of these in Mr Ashton's report is lengthy but as there are no specific conclusions, they are not covered here.

Mr Ashton concludes that on the basis of the valuation points available to him, he does not believe the value of the business would be any lower than £3.00 per share. Furthermore, there is likely to be significant upside beyond this value, the extent of which depends on the pace at which the liquidity issues of the credit crunch unwind. In that case the share price might return to levels seen prior to the bank run, if not higher.

Would the Assumptions in the Compensation Order be Normal?

Mr Ashton was asked by SRM whether he would have used the assumptions in the Act and in the Compensation Order, absent any requirement in the legislation. His answer was no.

What would be the Effect of the Assumptions in the Act?

Mr Ashton was also asked what the impact on the valuation range would be from the provisions in the Nationalisation Act related to the valuation assumptions.

He responded that with in such circumstances he would likely value it on the basis that it was in a formal insolvency procedure, most likely administration. But in his view, as previously stated, this would be inappropriate.

He also comments, supported by the evidence of Mr Katz, that the value to be realized from the assets in these circumstances is likely to be less than book value, while additional liabilities are likely to arise in administration. Empirical evidence suggests that in administration, there is, almost invariably, no payout to shareholders. Hence the value to shareholders would be nil in such circumstances.

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Furthermore, the assumptions in the Compensation Order are not likely to make any significant difference and merely serve to further restrict the valuer's ability to apply his own judgment as to the appropriate basis of valuation.

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