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Editorial

In this month's edition we are fortunate to have an important contribution from Malcolm Howard, who explains the 'Prime Test' he applies to potential investments as part of his 'Simple Tests to Avoid Disasters' series. We are also very pleased to have two contributions this month from Mohammed Amin on different aspects of his investment practices. All three articles are fine examples of UKSA's belief in encouraging members to share their unique expertise for the benefit of the wider membership.

Once again we have a detailed article by Bill Brown, who offers us his 'Everyman's Guide' to the law surrounding the Northern Rock case. The treatment of Northern Rock's shareholders has been a lengthy and contentious saga and we are grateful to Bill for sharing his encyclopaedic knowledge and drawing out the lessons to be learned.

A letter from Ian Jessiman reminds us that the impacts of private equity go beyond the narrowing of choice for investors in listed equity.

News on another front also concerns a narrowing of choice for retail investors, as Ryanair plans to delist from the London Stock Exchange.

Of course, EU-based airlines face a particular challenge post-Brexit given their obligation to adjust their shareholder base to ensure they are majority EU-owned. Ryanair may not be a large component of the LSE, but it will undoubtedly be a key protagonist of any future consolidation in the airline sector and investors seeking exposure to it will now have to buy the Dublin-listed stock. The Ryanair news comes on the heels of the announced departure of BHP Group, the miner that is switching to a primary listing in Australia after ending a dual listing arrangement that has been in place for twenty years. Brexit has also been a factor in the decisions by Hammerson plc and Segro plc to take secondary listings on EU exchanges to maintain wider equity market access.

Helen Gibbons

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Simple tests to avoid disasters
Test 2 – The Prime Test

by Malcolm Howard

For over twenty years I have analysed published accounts for the sole purpose of attempting to make profitable investments. In about 25% of those companies analysed I believe that there is a potential error in the accounts through either auditing failures or imprudent accounting.

In some cases, however, I am absolutely certain that something is very wrong. I come to this conclusion when the 'Prime Test' fails for three consecutive accounting periods. In such cases, there is a 50% probability that the company in question will go bust. The idea behind the 'Prime Test' is a simple one:

Cash inflow from Operating Activities (found in the Cash Flow Statement) must be higher than Net Profit (the bottom line of the Income Statement). The logic behind this is that the Income Statement includes charges such as depreciation, amortisation and share-based payments that have no impact on cash flow. If the Prime Test fails, it means there is either a major problem with working capital or huge amounts of money are being paid into the company's pension scheme. Problems are:

Debtors (receivables) are too high. This can be due to sales being taken early, customers not happy with the goods or services received or poor credit control.

Stocks (inventory) are too high. The cause of this could be a major order will be despatched early in the new accounting year, the company's business is growing or they are overstated by count or by the fact that some of the stock is simply not saleable.

Creditors are being paid quickly at a far faster rate than debtors are paying money in. This is a sign that the company's creditors are demanding to be paid 'cash with order'. Two examples are below:

Land Securities Group	2020 (£'m)	2019 (£'m)
Net Loss	(832)	(119)
Add back: net deficit on revaluation of investment properties	1,000	441
Real profit	168	322
Net cash inflow from operating activities	401	424

The Prime Test passes, as cash is greater than profit. Note that for property companies we have to add back losses on revaluation or deduct profits on revaluation, as these are not real profits or losses, but merely reflect the concept of 'fair value'. The profits or losses are not real, as they are unrealised and reflect theoretical changes in valuation.

Carr's Group	2020 (£'000)	2019 (£'000)
Net Profit	10,922	13,624
Net cash inflow from operating activities	18,060	12,600
Prime Test	7,138	(1024)

In this case, the Prime Test failed in 2019. It transpired that there was an outflow of working capital in excess of £5k, but this was clearly a temporary problem as there was a massive inflow the following year. One failure is not a problem, although it is worth looking at. Concern increases as failure continues. It must be noted that the Prime Test applies to all companies except banks and insurance companies. Note also that house builders usually fail this Prime Test, but in this case there is not a problem. The reason

is that when they buy land this is classified as stock (inventory), so they appear to have an adverse working capital, whereas they effectively have bought an asset. Next we can look at Carillion plc:

	2016 (£'m)	2015 (£'m)	2014 (£'m)	2013 (£'m)
Net Profit	130	139	128	106
Net cash inflow from operating activities	73	73	124	(78)
Prime Test	(57)	(66)	(4)	(184)

It can be seen that this company failed the Prime Test over four consecutive annual accounting periods, so something must be drastically wrong. So we test for stock and debtor days:

Stock (inventory) days	7	7	6	6
Debtor (receivables) days	138	117	138	133

We can see straight away that the debtors are a major problem. For this type of company we could expect debtor days to be between 30 and 60 days and maybe up to 90 days if credit control was poor. Telephone calls to long outstanding debtors will find out the reason for non-payment. The answers should result in a reduction of sales and cost of sales or an increase in the provision for bad debts.

Mohammed Amin wrote in the August 2021 issue of TPI that due to Carillion plc he had suffered a large personal loss. He argues that this company's accounts were misleading. He then details the steps UKSA and ShareSoc are taking to improve the position. Now while this is an admirable initiative that might improve the standards of auditing, it will not resolve the problems relating to imprudent accounting.

The Times (September 28) reported that the Financial Reporting Council had fined Grant Thornton £2.3 million for their inadequate auditing of Patisserie Holdings (Valerie). Their lead auditor on this job, David Newstead, was fined £87,750 and banned from carrying out statutory audits for three years. Grant Thornton will also pay this fine.

I wrote to my MP, the Rt Hon Chris Grayling, complaining that IFRS accounts, especially 'fair value' were not prudent. I have now had a reply from Lord Callanan at the Department for Business, Energy & Industrial Strategy. His reply includes: "*Under the conceptual framework financial statements must present a neutral depiction, which is one without bias in the selection or presentation of financial information. That neutrality must be supported by the exercise of caution when making judgments under conditions of uncertainty.*" Lord Callanan's reply to my email seems to adequately specify the problem. It seems that auditors must be neutral and accept directors' opinions that (for example) there is no uncertainty with regard to debtors. Therefore, when it comes to imprudent accounting, directors and auditors are bullet-proof. Should we get another 'Carillion', they will simply say:

These accounts have been prepared in accordance with International Financial Reporting Standards (IFRS). Under IFRS, accounts do not necessarily reflect what has actually happened. As auditors, we are not required to apply the test of prudence. We can only insist on adjustments when we are certain there is a need to do so.

We need to get back to accounts that include at least two of the former three safeguards:

- The historical cost concept – accounts reflect the actual transactions that have been made. This means that rent paid is shown as rent and not interest. It means that the amount banks pay to a company's creditors (reverse factoring) is shown as 'debt' in the balance sheet and not 'creditors'. It means that 'fair value' adjustments and 'share-based payments' are not included in the accounts.
- The prudence concept – there should be adequate provisions where there is a *doubt* about the validity of any asset or liability. Such doubt must exist when certain tests (for example stock days and debtor days) are assessed to be outside normal expectations.

Until we get prudent accounts back, then investors are subject to 'caveat emptor' (let the buyer beware), so to protect ourselves we need to carry out the tests that auditors won't do on our behalf.

The Dangers of Private Equity

a letter from Ian M. Jessiman

I read with interest Harry Braund's article 'The onward march of private equity' (August TPI p.3), but was disappointed when I turned over the page to find I had reached the end! I had hoped to learn 'then what?' but am still left with more problems than answers.

As a private investor I find I am being 'inundated' with unwanted cash payouts, just when it is particularly hard to find a safe home for them. At the same time my 'nest egg' investments, carefully selected for my declining years, are being taken away from me willy-nilly so that others may 'blow the cash' here and now, quite possibly on unnecessary and wasteful frivolities or goods. They are seeking to enrich the present generation (= themselves) at the expense of past and future generations. Another example of 'buy now pay later' or of expecting someone else to pay?

No doubt private equity organisations have financial expertise, but they would not necessarily have the particular qualifications needed for running their victim businesses or companies. In trying to achieve their aims there would seem to be a serious risk of their cutting corners and reducing standards (health and safety, animal husbandry), selling off freehold property (for sale and re-lease) or failing to contribute properly to pension funds. We have also already seen the danger of allowing foreign-based organisations to control home industries – the government has had to pay large sums to CF Industries (based in America) to maintain adequate supplies of CO_2 essential for our food suppliers and other businesses.

Some years ago, I tried my luck as a 'business angel'. When my first company had produced its product ready for marketing we met to decide the starting price. I had expected that we would assess the costs incurred in the manufacture and add a reasonable profit margin. I was frankly amazed that the calculation consisted purely in speculating how much we could get! This brings me to ask, is greed an unavoidable and inherent part of Capitalism? Or is it a flaw that has crept in? Can it only work if personal avarice is part of it? I am optimistic enough to hope not.

Whatever we think about that does not excuse us from asking whether capitalism is right or wise in seeking to extract the maximum financial profit from any business or enterprise here and now? In the long term no company should run purely for the enrichment of its shareholders. To succeed it must provide the public with something (goods or services) which it wants and, preferably, needs and is prepared to pay for. In addition it must provide its employees with jobs which allow/enable them to achieve a reasonable standard of living, including an adequate pension. A successful company ought to show appreciation of its employees and instil in them a pride in the firm, thus enhancing their job satisfaction. This is easily lost when a firm is taken over by a faceless financial enterprise with little, if any, knowledge of what the company actually does or how it does it.

Furthermore we cannot ignore the burning issue of the future of the planet. Extinction Rebellion (amongst others) is at pains to warn us that the earth's resources are finite and not to be carelessly used or wasted. We are beginning to recognise what amounts to an infinite demand for finite goods. Given that, global warming or not, the resources of the planet are finite, we ought surely to bear in mind the needs of future generations and to be concerned to divide things fairly between generations and oppose any waste of resources.

It may well be that the government has to intervene to limit the sale of our businesses abroad, but even that could not provide all the answers. If nothing else, the current pandemic has led to some increase in mutual concern in society. Would it be possible for capitalism to show some consideration for all of society? In answer to the question 'then what', would it be wildly optimistic to hope for the development of 'Considerate Capitalism'?

Report on Sharetalk in the South-West

by Alan Cane

ShareTalk (UKSA in the South-West and Midlands) began its autumn series of meetings with a Zoom session on 8 October. Alex Heslop, a PhD researcher in the Department of Typography & Graphic Communication at Reading University, spoke on the subject of 'Corporate Annual Reports 1980-2000'.

Alex is a designer and she concentrated on that aspect, reminding us also how regulatory considerations have played a large part in the content of corporate reports since the 19th century. Few 20-year periods can have seen greater change on the financial scene than the one her research focuses upon. Think back: Margaret Thatcher, privatisations, popular capitalism and some notorious corporate scandals.

With the internet still in its infancy, paper remained king in the 80s, and the Annual Report was probably the best way for private investors to gain an overview of a company that interested them. Millions of 'Sids' received them for the first time. Alex had learned to question some of the favourable images projected by companies, a practice that we can hardly expect them to abandon. But while most UKSA members might seek dissonance between a company's claims and what actually happened in the lines of financial reporting, Alex drew her conclusions from text, pictures, and the first-hand experiences of third parties involved in producing ARs.

All this led to a fascinating Q&A session that enabled members to recall their personal experiences, both light-hearted and very serious. My favourite was a description of how Lloyds Bank incorporated an animated Black Horse into the page corners of one of their publications! In contrast other members recalled the events that led to the Cadbury Review, and its long-lasting and beneficial impacts on corporate reporting.

When the conversation turned to how we use ARs now, key conclusions were that [1] they can provide a baseline from which a company's stated strategic objectives could be compared with actual progress, and [2] the financial statements may best be used as part of a series (some of us employ this approach) to track longer-term trends and changes. Again, this can help us to decide if management's claims are justified. The conclusion: read with caution.

This was an excellent two-way session in which we and the speaker were able to learn from each other. Alex can be contacted through David Riches if members who were unable to join the Zoom session feel they can contribute insights that may help her research. She works on the PhD part-time and it's a long-term project. We wish her every success.

A word of thanks to Peter Wilson

After 21 years' service to UKSA as the active Chairman of the South-West, Peter Wilson is stepping down.

UKSA is immensely grateful for Peter's huge contribution. Over the past two decades he has organised over 100 company meetings and two national conferences, helped by many SW members, notably Drs Catherine and Ted Moss.

To Peter's great surprise, he has just been nationally recognised by CPRE, the Countryside charity, with a 2021 National Volunteer Award. More details can be found on page 11.

How I became a quantitative investor

by Mohammed Amin MBE FRSA MA FCA AMCT CTA(Fellow)

Editor's note: although Amin is a member of UKSA's Policy Team, he is writing in a personal capacity.

There are two very different ways of investing in individual shares: qualitative and quantitative.

A. Qualitative

I have been doing this for about 45 years.

A company comes to mind. I might see its shops or factories or read about it in a news story or a computer magazine. It might be recommended in an investment magazine.

My next step is always to read its accounts. That is essential for understanding how the company does business and understanding its strategy. The figures allow me to form some kind of view on its relative cheapness or expensiveness.

However, the fundamental decision to invest (or not) relies upon answering one very difficult question: "How will the company's business fare in the future?"

Will it maintain its current profitability level? That might be fine provided the shares are cheap enough. Will its business decline? Will its business grow spectacularly? The future is hard to predict. Sometimes I have been right, but often I have been extremely wrong.

Until about six years ago, that was the only way that I selected individual shares. Indeed, it was the only way available to me to select individual shares.

B. Quantitative

Decide what numerical criteria a desirable company should have. Run a filter over the entire universe of listed companies in which you could invest. Running the filter results in a list of companies, which the process may rank, depending on your filtering criteria.

Invest in the highest ranked companies diversifying by allocating roughly equal amounts of money to each.

With this approach, there is no attempt to assess a company's business strategy or future prospects. All of the intellectual effort goes into deciding the rules that comprise the filter for buying and the rules for selling.

C. My personal history with quantitative investing

Until about six years ago, I had no access to technology that would allow me to run a filter over the universe of investable shares.

The falling cost of technology has made all the difference. At the end of 2014 I subscribed to the online Stockopedia service. The company buys in stock market data and provides online tools for processing that data. You can access calculations already made by Stockopedia as well as designing your own filters, graphs etc.

I was led to that decision by some of my investment reading. In particular the book "The Little Book That Still Beats the Market" by Joel Greenblatt and "Quantitative Value: A Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors" by Wesley R. Gray and Tobias E. Carlisle.

Since then, I have bought very few shares on a qualitative basis. Instead, starting small, I have been

gradually expanding my quantitative portfolio as I tested out the process and became more confident with it.

D. Why did I change?

As an investor, I am probably not too bad when it comes to deciding on shares to buy. However, I have always struggled with selling.

The selling problem applies both with companies which increase in price after purchase, and companies where the share price declines. As someone who has read a great deal about behavioural finance, I recognise that I suffer from "the disposition effect" whereby you get attached to something simply because you own it.

The investment maxim of course is: "Don't fall in love with your shares, because they will never fall in love with you!" However, it is very difficult to apply in practice.

Within my quantitative portfolio, I have never had the slightest psychological problem with selling. If the rules say "Sell", then I sell without the slightest trace of regret, regardless of whether the price has gone up or down. I no longer feel the slightest tinge of regret selling shares at a loss, which in my qualitative portfolio I have always found very difficult to do.

E. What have been the results?

As a chartered accountant and mathematician, the one thing I am good at is computing the score! The table below is extracted from a spreadsheet that I update every six months (after a delayed beginning, since I created it 2½ years after my quantitative portfolio started.)

That spreadsheet looks at the total return (change in capital value + dividends received) in each period, and computes two things:

1. The internal rate of return during that period.
2. The cumulative internal rate of return on the portfolio from 1 July 2015 to the end date of the period.

For the avoidance of doubt, there is no way for readers to check the cumulative IRR against the periodic IRR figures, because one needs the actual portfolio cash flows to do that.

Period start	Period end	Current period length (days)	Current period IRR	Cumulative IRR from 1 July 2015 to the end of the current period
01/07/2015	31/07/2017	761	27.68%	27.68%
01/08/2017	31/12/2017	153	55.14%	35.71%
01/01/2018	30/06/2018	181	30.93%	34.23%
01/07/2018	31/12/2018	184	-31.63%	6.59%
01/01/2019	30/06/2019	181	6.62%	6.60%
01/07/2019	31/12/2019	184	22.33%	10.40%
01/01/2020	30/06/2020	182	-1.18%	7.62%
01/07/2020	31/12/2020	184	36.85%	12.79%
01/01/2021	30/06/2021	181	46.96%	18.44%

When the quantitative portfolio started in July 2015, it represented only 0.38% of my family's total

equity portfolio. (That is almost certainly why I did not bother with the spreadsheet initially.) The quantitative portfolio has grown steadily as I have transferred money to it from the sale of previously held shares which had been purchased qualitatively. By the end of June 2021, it had become 15.69% of the family portfolio.

That 41-fold increase (overwhelmingly from transferring in money from selling qualitative shares) demonstrates my growing personal confidence in the quantitative approach.

It is not easy to be certain whether the results are good or not. I always say that in the right environment any idiot can look like a good investor!

However, as time goes on, and the period during which I have been investing quantitatively includes more difficult stock market conditions (the second half of 2018 and the first half of 2020 were certainly very difficult environments), the more confidence I have that there really is something in the methodology.

My ambition is simply to do 2% per year better on average than investing in an index fund. Until now, I have never tried comparing my quantitative portfolio's results with an index, because I expected the calculations to be too difficult.

However, while writing the article, I thought of a methodology, by replicating what would have happened if each monthly cash flow had been invested in, or withdrawn from, a holding in an index. The index I used was the MSCI AWCI in GBP, which "captures large and mid-cap representation across 23 Developed Markets and 27 Emerging Markets".

My calculations show an IRR of 14.48% from investing in the index during the period from 1 July 2015 to 30 June 2020, compared with my quantitative result of 18.44%, in my favour by 3.96%. However, the index concerned is a net index, without reinvestment of income, whereas my quantitative portfolio results include dividends. The current index dividend yield is 1.74% and deducting that reduces my outperformance to 2.22%. (In practice, a real ETF would entail some charges.) What this exercise shows yet again is how much effort it takes to outperform the market, even if you succeed in doing it.

F. Concluding comments

I have deliberately not mentioned any specific rules that I apply because I believe it is important to develop the rules yourself.

However, I believe that if you take your investing seriously, you should allocate a personal budget for money to spend on information resources. Once I decided to do that, it no longer felt expensive paying for Stockopedia.

In my opinion the great advantage of the quantitative approach is that it puts your focus on trying to devise better rules, which I think is easier than evaluating individual companies' business strategies and forecasting their prospects. Ed Croft of Stockopedia has compared quantitative investing to farming, while qualitative investing is like hunting.

Monitoring investments with Excel – Part 1

by Mohammed Amin MBE FRSA MA FCA AMCT CTA(Fellow)

Editor's note: although Amin is a member of UKSA's Policy Team, he is writing in a personal capacity.

I have been a spreadsheet user since around 1981 when the Manchester tax department of Arthur Andersen bought its first IBM PC. That was in the days of VisiCalc. I was self-taught; ironically about a year later I ended up teaching the Manchester tax department's first spreadsheeting course.

Spreadsheeting skills vary. In the early 2000s, I met one of PwC's professional Excel model builders. Despite my having over 20 years of spreadsheet experience, I was still awed by the complexity and

elegance of the model that he built for a major mutual client.

Conversely, I will never forget the member of staff who created a spreadsheet of rows and columns, and then used her calculator to add up the columns, finally typing in the column totals by hand. For her, Excel was only a word processor for numerical tables. She really did not know how to make Excel add a column of numbers!

The real moral of that story is firms should not skimp on training costs by assuming that staff can use the software the firm provides them with.

Since the mid-1990s, I have used a spreadsheet to monitor our investments. Since starting that spreadsheet, I have slowly added more features, making it far too complex to cover in a single article. Instead, I intend to write a series of articles, each covering just one bite-sized aspect of Excel.

The first one is below.

Is your capital result good or bad?

You bought 100 shares of ABC plc for £1,000. They are now worth £1,900. Has it been a good investment, a bad investment, or a mediocre one?

Obviously, it depends on how long you have held the shares. Assume that you have owned them for N years.

Most investors will remember the compound interest formula from their schooldays.

$$\text{Future Value} = \text{Present Value} \times (1 + \text{Rate of Return per Period})^{\text{Number of Periods}}$$

Here, $1{,}900 = 1{,}000 \times (1 + R)^N$

$1900/1000 = (1 + R)^N$

$1.9 = (1 + R)^N$

$1.9^{(1/N)} = 1 + R$

$R = 1.9^{(1/N)} – 1$

Before scientific calculators became available, calculating the Nth root of a number required either log tables or a slide rule. Excel of course has the ability to calculate Nth roots built in.

If N = 2, say, your annual rate of return of is 0.378, or expressed as a percentage 37.8%. That is extremely good.

Conversely, if N = 20, say, your annual rate of return is only 0.033, or expressed as a percentage 3.3%. Unless you have also received a reasonable rate of dividends (since the above calculations only consider capital values) you should feel pretty disappointed. My personal assumption, based on international stock market history, is that the long-term nominal rate of return on equity investments should be about 8%.

There are two linked PDF files. The first file shows what the Excel spreadsheet should look like. The second file shows the formulas you enter into Excel to carry out those calculations. There is no substitute for learning how to enter those formulas into Excel yourself.

In passing, Excel contains many built-in financial functions.

There is no harm in using them, but you should ensure that you know how to do the calculations from first principles. Otherwise, you are blindly reliant upon the Excel financial function getting it right, and there is always the risk of using the wrong function by accident.

The next instalment: Doing arithmetic with dates.

The good, the bad and the ugly of dual class shares

by Sue Milton

Her Majesty's Treasury (HMT) consulted on the listings regime that companies have to follow in preparation of an initial public offering (IPO). One of the issues under debate was allowing the issue of dual class shares (DCS). Question 2.2 asked about the demand for DCS among issuers and the related benefits and risks for investors.

The DCS structure:

1. DCS enables some shares to carry more weight than others, effectively giving some shareholders more voting rights.
2. DCS allows control to be held by the minority of shareholders.
3. The basis of equity ownership – one share, one vote – is overridden.

DCS is not new, having started in the 19th century. DCS occurs mainly in founder-led companies. It is easier to understand DCS when looking at those type of companies.

The Good: key advantages of DCS:

1. For founders holding weighted shares, they retain control of the company and override market considerations, allowing them to pursue their vision.
2. For investors who believe the founder is crucial to the future success of the company, DCS is a way to retain the founder.
3. Creates a 'win/win' as the combination of vision and control enhances company success for the benefit of all shareholders.

The Bad: key disadvantages of DCS:

1. Founders cannot be voted off – fine initially but not necessarily good, as many founders are great entrepreneurs but poor leaders of companies where operational control has to be shared.
2. With power held by a minority, governance suffers because the demand for transparency and accountability can be ignored.
3. Non-DCS shareholders lose incentive to maximise the full potential of the company as fewer benefits – dividends – will accrue to them.

The Ugly: what happens if applied to the Premium listing segment of the London Stock Exchange?

1. The majority of shareholders will be disenfranchised, with retail shareholders bearing the brunt of a 'double whammy': even less voting power applied to a small pool of shares when compared to those held by institutional shareholders.
2. The whole of the governance structure, based on equitable treatment of all shareholders through the practice of one share one vote, is destroyed.
3. The UK's corporate governance and stewardship codes, covering company boards and institutional shareholders respectively, are undermined.

These are my personal views. I would love to hear others' views.

To read UKSA and ShareSoc's views, please read our joint response to HMT https://www.uksa.org.uk/news/2021/02/02/review-uk-listing-rules.

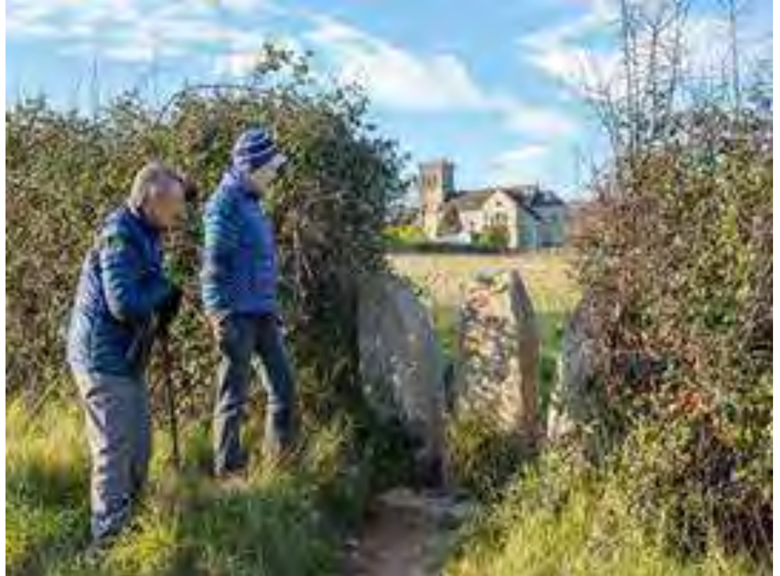
Peter Wilson and CPRE, the Countryside Charity

Peter Wilson, the former Chair of UKSA's South-West region, has been nationally recognised by CPRE, the Countryside charity, with a 2021 National Volunteer Award for years of service to the Charity.

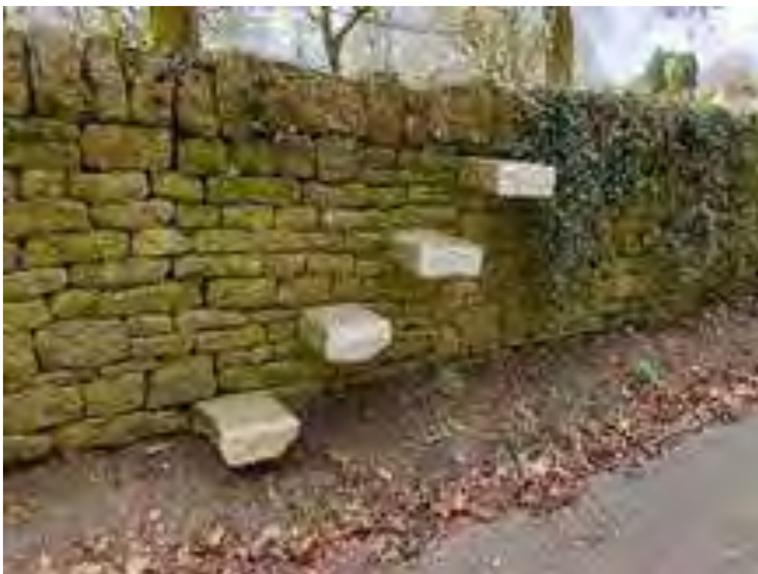
The Award for "inspiring many people to explore the countryside" was formally presented at the CPRE National Conference in Birmingham. In receiving the Award Peter paid tribute to some 250 individuals and their families who are walking the pathways of Gloucester discovering stiles and recording their current condition. 'This Award is theirs' not mine,' he said.

An example of Peter's work is the Gloucestershire Stone Stiles Project.

For centuries stone stiles have allowed pedestrian access across the countryside using ancient pathways which predate both land enclosure and the Romans. Now their survival is threatened. They are easy to maintain, and yet, understandably, they are seen as impediments to walkers rather than markers of ancient rights of way and historic landscape features. Using the record now being created it should be possible to establish what stiles have been lost in the past decade, and by providing this information to the county and parishes maybe encourage an effort to safeguard them. In most instances land owners are doing their best to preserve their stiles even where they have had to be modified to keep cattle from straying, but they are steadily being lost.



Walkers pause by a rare double squeeze stile, near Whiteshill. Photograph courtesy of Maggie Booth



A large stile at Shipton Moyne. Photo courtesy of Jayne Tovey.

Stiles, especially stone ones, are a surviving testimony to ancient pathways. Even when ancient pathways were inconvenient to neat rectangular fields at the time of enclosures their locations were respected. Thus stiles were necessary to contain livestock. They should be protected as visual evidence of the past.

We wish Peter continued success in his work for the countryside.

Erratum - article on Capital Gains Tax by Roy Colbran in TPI 213

The final passage of the 'Chatels' section should read "assets expected to have a lifetime of less than 50 years" (not five years). Apologies!

The Law and Northern Rock – Everyman's Guide

by Bill Brown

In earlier articles I have tried to present the facts as simply as possible, but the story of Northern Rock is extensive and complex. I have tried to deal with the "complexity" issue by addressing various matters from different aspects as simply as can be achieved.

We live in a democracy and we are acknowledged world-wide as a people who are proud of our heritage of "abiding by the law"; we are on the whole a "law abiding people". When "laws" are created, we obey them. However, we expect those laws to result in justice for everyone.

Our principal concern for the present purposes is with "laws" passed by Parliament. Our Parliament is comprised of 650 Members, all elected by us, the population of the UK, supplemented by about 800 unelected Members of the House of Lords, many of whom are "life peers" and political appointees. One purpose of so many individuals is to ensure, at least in principle, that they are representatives for us; thus when they pass laws, they are observed (by most people).

We should recognise from the outset that two entities are involved in refuting the claim by shareholders for compensation. They are: 1. The Government; 2. The Court system. Those two entities are supposed to be independent of each other and to work for our overall benefit.

In the debate on the Northern Rock (Special Provisions) Bill, Sir William Cash, MP (Con.) said: "*The Bill does not have the urgency that the Government seem to claim for it by the means of its introduction, but they are railroading a series of parliamentary conventions. In introducing retrospective legislation, the Government are in fact trying to avoid the prospect of introducing a hybrid Bill by transferring the provisions over to a hybrid instrument—if that is what it turns out to be—while dealing with the matter in a way that will bypass the courts if they can possibly get away with it*".

This is an interesting comment since the subsequent Court proceedings initiated by shareholders failed because the Compensation Order set artificial conditions based on "assumptions" that were applied only to Northern Rock and which ensured that "Lord Justices" had only a discretionary ability to set them aside.

Nationalisation is an accomplished fact and cannot be undone, so it was accepted as a "temporary" measure.

Our first consideration is the laws involved. There are two ways in which laws can be interpreted:

A. Literally, according to the "letter of the law".

B. According to the spirit or intention of the law.

The second way involves the principle of Equity or "natural justice." English Courts are presided over by "Judges" who are referred to as "Lord Justice X," etc., which describes their principal function which is to administer Justice that produces an equitable and fair judgement for everyone.

In English Law, the law of Equity has now been assimilated with Statute Law (law created by Parliament). Lord Justices are expected to take both into consideration. Common and statutory law typically refer to laws based on precedence and the rulings of Justices who hear a case in a courtroom. Equity, on the other hand, refers to laws that are similarly established by court rulings but deal with judgment and justice through equitable decisions. Equity law supersedes common law and statute law when there is a conflict between the two and neither can appropriately bring the correct verdict.

It is a source of law peculiar to England and Wales and is the case law developed by the (now defunct)

Court of Chancery. Equity prevails over common law, but its application is discretionary. It is based on the principles of "natural justice", which is a concept of English Common Law.

Some Justices may exercise that discretionary power; others may choose, for a variety of valid reasons, not to do so. One reason may be that they do not see it as being appropriate in a particular case.

Statute Laws are complex and must cover a wide range of circumstances, so they must also be interpreted in a flexible manner, which is achieved by means of a fusion of Common Law, Statute Laws and the Law of Equity.

Parliaments around the world devise laws, some of which are designed to cope with specific as well as universal matters. It follows, therefore, that the effects of laws can vary. That laws can be different from country to country emphasizes the fact that the interpretation of the law is determined by the considered opinions of one or, as in the case of some Courts, a majority of very experienced Lord Justices.

If we stay with "the letter of the law" principle, we shall not necessarily be able to cover all individual circumstances and before a person can understand and interpret complex "laws" he must be an experienced legal practitioner. It is not possible for laymen to achieve that level of understanding.

On the other hand, most people understand what is "fair and equitable". Governments often select this as their "rallying cry" for much of what they seek to achieve whilst in office.

Returning to Northern Rock, we must consider which Laws were principally involved. They were:

The Banking (Special Provisions) Act 2008

The Northern Rock Shareholders Compensation Order

The Freedom of Information Act 2000

Insolvency Act 1986

Banking Act 2008

The Banking (Special Provisions) Act 2008 It is important to note that it was a temporary Act with a life of one year and that the "Special Provisions" related to the *Assumptions* that had to be made in the case of Northern Rock only. It was passed as a "stop-gap", because the full Banking Act which followed in February 2009 had not been enacted but could have been enacted in the five months prior to the date of nationalisation. It was known that there was an awareness of its unavailability. In its place, the "Special Provisions" Act was hurried through Parliament retrospectively in a few days during the week that followed the declaration by the Chancellor of the nationalisation of Northern Rock.

The Chancellor of the Exchequer, Alistair Darling, told the House of Commons at the first reading of the Bill on February 18 that: *"The Government have no intention at present to use the Bill to bring any institution other than Northern Rock into temporary public ownership."*

The Northern Rock Shareholders Compensation Order 2008, taken with the above-mentioned "Special Provisions" Act, was deliberately devised to ensure that a valuer had to assume a NIL value for the shares, notwithstanding that within recent months Goldman Sachs had identified Equity of £2.8 billion, part of which was attributable to shareholders' interests. The Order applied ONLY to Northern Rock.

The Freedom of Information Act 2000. This Act enables adult residents of the UK to access information relating to most public offices, including Government entities. It is to be noted that whilst the Act applied to the Government-owned holding company (UK Asset Resolution), it did not apply to its wholly owned subsidiary, Northern Rock Asset Management (later known as NRAM), on the grounds that NRAM had a separate Board of Directors operating at "arms length" from Government. As Government policies had to be followed within NRAM, the extent of "arms length" is debatable.

Did that matter? Yes, it did, because it enabled NRAM to be operated without scrutiny as a Private Company, even though it was Government-owned and effectively controlled, in other words not transparently.

Insolvency Act 1986. This Act provides for two events, either of which can be a basis for declaring a Company Insolvent. A). The Company is unable to pay its due debts. However, a Company operating as a Bank is treated differently. If it is solvent, it can always access liquidity, also known as LOLR loans, not from the Government but from its Central Bank. Therefore, this circumstance does not apply to a solvent bank. B). Where the Liabilities are greater than its Assets. That can result in any Company being Insolvent and therefore it does apply to insolvent banks, but Northern Rock was a solvent bank, as was declared many times. The Act makes no provision for cases where a Company is deemed to be "effectively insolvent" (as the Chief Secretary to the Treasury suggested), nor does it provide for a Company to be "assumed" to be insolvent.

"Assumptions," applicable only to Northern Rock, therefore had to be created by a Ministerial Order (as noted above).

The Banking Act 2009. This Act was a late enactment of the law adopted by all other G8 countries in 2003, but not by the UK until 2009. It was principally an Act to provide for the Resolution of Banks in situations, such as that in which Northern Rock found itself, and which is to be the responsibility of the Bank of England. It should be noted that the Act required "Nationalisation" to be a "last resort". Note also that the parent Company of NRAM was called "UK Asset Resolution" long before the 2009 Act was passed. Did it apply to NRAM, a Company created in 2010? No, because, although its Assets were all derived from Northern Rock Bank, it was regulated by the FSA, not as a Bank but as an Asset Management Company. This was because, included in the definition of a Bank is that it must accept deposits from the public, which NRAM was specifically prohibited from doing. One is left with the impression that the separation of NRAM in 2010 was deliberately arranged to ensure that it could not be subject to this Act.

The Act also provides for the compensation of shareholders and states, *inter alia*: (11.16) *"The authorities do not intend to profit from a resolution of a failing firm"*. Contrast that statement with that of the Chancellor in 2008, less than a year earlier: *"Under public ownership the Government will secure the entire proceeds from the future sale of the business in return for bearing the risks in this period of market uncertainty."* , notwithstanding that HM Government acquired NR at no direct cost.

Also in the Banking Act 2009 Act, Sec.11.2 states: *"In order to strike a balance between public and private interests where property has been transferred compulsorily (for example, as a result of an exercise of the share transfer powers), it is appropriate to make provision for compensation to be paid, which is normally required to be an amount reasonably related to the market value of the property in question."*

In the case of NR, "reasonably related to the market value of the property in question" can now be reassessed with reference to the extent of the profits and surplus assets finally accruing to HM Government as at 2020 rather than to the hypothetical and wrong conclusion that was calculated in 2007/8.

To continue the Northern Rock saga, it may be possible to argue, as the valuer did, that in February 2008 the liabilities of Northern Rock exceeded the realisable value of the assets at that time, but was that a valid assessment? No, because it had no real basis, although up to a point some may justify it by application of "the letter of the law" in respect of the "assumptions" that had to be observed.

Lord Justice Lewison, one of the three Appeal Court Justices in a case brought by Harbinger Capital, said *"It is important to emphasise that the assistance that the Bank of England had provided was liquidity support; that is to say, the Bank's intervention enabled Northern Rock to pay its debts as they fell due. The Bank's intervention was not designed to shore up Northern Rock's balance sheet. That would have been incompatible with the principles on which the Bank acts as lender of last resort. There is no evidence or finding that Northern Rock's balance sheet was increased as a result of public sector support. As far as the evidence goes Northern Rock had a surplus of assets over liabilities when the Treasury first intervened, when the Bill that became the Act was introduced into Parliament and at the transfer time itself. The consequence of liquidity support was that Northern Rock was*

enabled to continue as a going concern."

"Without that support, as was common ground, it would have had to have entered administration or liquidation, but it would have done so on the basis that the starting point of the administration or liquidation was a company whose assets, as shown in its balance sheet, exceeded its liabilities."

The latter is an important point because it acknowledged that there should be a value to the former shareholder's shares that has not been accepted by HM Government, nor by its professional advisers. At the same time, everybody recognized that NR could not raise loans from other banks (interbank market) as it normally did, because that market had shut down completely.

Liquidity support was first given on 14 September 2007. The HM Treasury press announcement contained the statement that *"the FSA judges that Northern Rock is solvent, exceeds its regulatory capital requirement and has a good quality loan book"*. Three days later the Chancellor of the Exchequer announced that the government would guarantee existing deposits in Northern Rock. The guarantee was paid for by a fee charged to Northern Rock. That Guarantee, although paid for, was never utilized. Therefore should it, in terms of "Equity", qualify as "State Aid"?

Each year Northern Rock realised about one-third of its "teaser or fixed-rate" short-term mortgages, a fact that must have been known to the UK Government. Northern Rock held over £100bn of mortgages and the Bank of England had acknowledged that was sufficient to secure up to £40bn of Emergency Assistance (a fact not made public until 2014 when the Bank had a new Governor), but over a period of several months the Bank of England only advanced £26.8bn. It also acknowledged that property values would have to fall more than 50% for a loss to accrue on the loans (another of several facts that were not made public until 2014!!).

Of course, those were very large amounts which few would have regarded, at that time, as "normal" LOLR loans. Furthermore, they were of great concern in Government circles where, until that time, they presented a problem of a size the like of which nobody had previously experienced.

A mortgage bank, such as Northern Rock, receives income monthly on its total of mortgage loans, in this case at least £5bn per annum from over £100bn of mortgage assets. Remember that at the time a typical mortgage interest rate was 6.75%. Those assets were used, in total, to secure (during the period the loans were "novated" to Government) a maximum of £15bn of LOLR loans. On that basis alone "interference was not proportionate" and it was inconceivable that HM Government (or the "taxpayers") could sustain a loss.

Northern Rock had a substantial annual cash flow which, together with customary remortgaging, was able to repay the LOLR loans within a reasonable and normal three-year period. HM Government, not the Bank of England, subsequently loaned to NRAM a further £10.5bn, but why? The funds were allocated to NRAM to stimulate the UK mortgage market and to capitalize a new separated NR, but NRAM as such could make no use of either amount, yet it alone was specifically made responsible for repayment with interest by a Conservative Government.

In the English Appeal Courts the determinations of the Lord Justices were not necessarily unanimous. In the Court of Appeal Lord Justice Laws, sitting with Master of the Rolls Lord Clarke and Lord Justice Waller, accepted that "Northern Rock's substantial assets ... will be as much a contributor to the sale price as will the support put in by the Government", but added "shareholders are likely to receive nothing". That is a clear acknowledgment that the court had not determined a valuation of the shares.

The ruling of that Court was made, despite the fact that documents obtained under Court "disclosure rules" (and which, it is understood, could not be made public at the time) showed that NR had been secretly accorded a substantial valuation which demonstrated that the Government and its advisers knew that, through nationalisation, they were acquiring a potentially valuable asset.

In a case brought by a Preference shareholder, Harbinger Capital in 2011, two of the Lord Justices agreed that the Government had acted within the law, as expressed in the Northern Rock (Special Provisions)

Act 2008, which was a temporary piece of legislation replaced by a full Banking Act in February 2009. The "Special Provisions" were a reference to the requirement in the Act that "assumptions" had to be made. The third, Lord Justice Lewison said *"Left to myself, therefore, I would allow the appeal on the question of interpretation; and remit the case to the valuer for reconsideration. However, since Mummery and Beatson LJJ disagree with my interpretation, the appeal must be dismissed."* Lord Justice Lewison also quoted the valuer as having said: "*I propose to assume that the best quality assets are realised and that the remaining assets on the balance sheet are of lower quality as they have more inherent risks.*"

The impact of this assumption was to turn Northern Rock from being a company which was balance sheet solvent (which it had been in reality both when the Bank of England first intervened and also at the transfer time) into a company which, in the hypothetical world, was balance sheet insolvent. As a result of the assumptions that the valuer made, the balance sheet value of shareholders' funds was reduced from a surplus of about £1.6 billion to a deficiency of about £2.4 billion. That was the inaccurately assumed basis on which the Valuer justified his "NIL Value" conclusion.

How can that be squared with the £7.8bn that HM Government derived from those same assets?

Lord Justice Beaton, in his interpretation of the case, stated: *"As was famously said in an earlier case by Lord Asquith, if you are bidden to treat an imaginary state of affairs as real, the statute says that you must imagine a certain state of affairs, it does not say that having done so, you must cause or permit your imagination to boggle when it comes to the inevitable corollaries of that state of affairs."* In other words, Beaton LJ indicated that the consequences of such an "assumption" are not be to be considered.

The ruling of the various Courts was on the lawfulness of HM Treasury's and HM Government's right to set the terms for determination of compensation. The Courts did NOT extend the judgment to the Equitable Right of Shareholders to obtain compensation or whether the Assumptions imposed on the Valuer were "Fair" or, as he said, "Unreal". The fact that three very experienced Appeal Court Lord Justices did not reach the same verdict illustrates that "the letter of the law" has to be interpreted and when "the law of Equity" is taken into consideration, the interpretation by individual Justices can vary.

The EU Court of Human Rights did not consider the Case for compensation. Their view was: "It is for the legislature and the (UK) government alone to determine the provisions of the compensation scheme". Also included in the ECHR judgment was: *"It may have been their (i.e. retail shareholders', in particular the 176,000 "small" shareholders') misfortune that their case was consolidated with the case of the two hedge funds. It is conceivable that a group of retail investors who had held the shares for long periods of time might have received a somewhat more sympathetic hearing from both courts."*

Bearing in mind that many MPs and others had misgivings about the activities of Hedge Fund Managers, one must consider whether those attitudes had an effect on the Court proceedings.

Regarding the "withdrawal and non-renewal" of loans, no differentiation appears to have been made between LOLR loans, provided legally and properly by the Bank of England with the balance subsequently "novated" to HM Government and then characterized as "State Aid". The original loans (LOLR) were from the Bank of England and should not represent "State Aid" from HM Government before they were "novated" in September 2008, even though HM Government, technically, had guaranteed them. "The novation" to HMT was unnecessary; the loans could have remained as LOLR loans from the Bank of England. The only valid reason for the "novation" was to ensure that anticipated profits would accrue to HM Government.

HM Government has subsequently defended its stance based on the various court proceedings, although none of the Courts mentioned above considered the question of shareholder compensation other than to rule that it would be "zero" and that only because of the "assumptions" included in The Banking (Special Provisions) Act 2008.

The nationalisation of Northern Rock was not temporarily as a "stepping-stone towards a return to the Private Sector" as a Labour Chancellor had declared (which may have involved continuation of LOLR support for another two years or so), but instead a "novation" into (debatably) State Aid from Government, which successive Conservative Governments maintained for an extended period of 12 years (notwithstanding that 167 Conservative MPs had voted initially against nationalization (see Hansard) and notwithstanding that the declared aim of HM Government was to have the loans repaid within as short a time as possible. It culminated in a profitable outcome for HM Government of £7.82bn. Therefore, all the talk of "taxpayers at risk" or "maximise the return for taxpayers" is nothing more than "rhetoric" or even a "red herring" if one has regard to the Bank of England minutes.

An individual "taxpayer's" involvement ends when his due tax is paid; after that tax revenue is subject to distribution by HM Government. HM Government has no intention of refunding taxpayers out of a profitable outcome.

How could it be proposed that Northern Rock was "insolvent" when it has produced, out of the "bad Bank" a total of £7.82bn for HM Government, after all fees and expenses had been paid to advisers, solicitors, barristers and others and despite the fact that many assets were sold at a discounted value which cannot be assessed because that information has been kept secret. Discounts were appropriate but at what rate? None of that would have happened if NR had not been nationalised.

Shareholder compensation should be reviewed NOW, when the full outcome of nationalisation has been determined, not in times of extreme financial stress in 2008 when nobody knew how matters would turn out. One has also to consider the income that arose since then and of which former shareholders have been deprived over a twelve-year period. Despite the extent of the financial crisis affecting the UK, it is significant that no other banks were "nationalised" during 2008.

Mr Caldwell's NIL valuation could be debated indefinitely if one relies only on Court proceedings and an interpretation of the "letter of the law". The legal debate on NR runs to many hundreds of pages, in and out of Courts. However, if considered according to the principles of a fair and equitable solution, it becomes clear that in the case of the former shareholders of Northern Rock "natural justice" was not delivered. The fact that Lord Justice Lewison reached a different conclusion from his fellow Lord Justices and that ECHR Judges considered that individual long-term shareholders "may have been more sympathetically treated" both support that conclusion.

All this could have been avoided if the Government of the time had agreed for shareholders to be paid reasonable compensation when Northern Rock, a solvent bank, was nationalised, assuming that was an appropriate action, instead of accepting the advice of Goldman Sachs, its USA adviser. It is not a question of the conduct of the Northern Rock Board, the Bank of England Governor, financial regulators, HM Government and its advisers, or even of ministers. Whilst mistakes were undoubtedly made by each of them, they were made in good faith, mostly in times of extreme financial conditions and stress of which no one knew the outcome or had any prior experience.

It seems to be apparent that there was too much reliance on "the letter of the law" and that insufficient consideration was given to the principles of "the law of equity" which would have dealt with the matter on an equitable and fair basis and that "natural justice" would have ensued and prevailed in "a real-world situation." It is important to remember that those Court cases took place either during, or shortly after, the height of the crisis when the financial situation of banks was in turmoil, here and in many other countries, and that the UK Courts had to take into account the "assumptions" specified in the Compensation Order because they had assumed a statutory basis.

Parliament is responsible for introducing LAWS and does so on many different matters, intended for the benefit of the law-abiding population. However, Parliament, independently from the Court system, has an ability to change such laws. It is within the powers of Parliament to take appropriate steps without recourse to the Courts, should it decide to do so on our behalf. The Court system has applied, to the advantage of a Conservative government, the strict "letter of the law" that must be followed without regard to the actual situation, which was quite different. On that basis the Courts may have produced a lawful determination, but not one taking account of the Law of Equity.

Is it appropriate for HM Government to maintain its stance whilst at the same time maintaining that it aims to treat everyone fairly?

What is important now is that the principles of "natural justice" are applied and former shareholders are awarded the compensation which, in the "real world" is their due. Even after payment of reasonable compensation, HM Government will still realise and retain a substantial profit. Remember, £7.8bn is not an insignificant sum.

Compensation can be paid out of Northern Rock funds, not by the Government and even less so by "the taxpayer".

Sue Milton comments:

There are two areas of interest. The first lies with NRSAG's appetite to obtain compensation from the profit Government has made from NRAM, Northern Rock Asset Management, the debt-ridden portion of the old Northern Rock that was retained by HM Government.

This is up to us to put in train. I recently posted on the NRSAG Facebook page UKSA Northern Rock Shareholder Action Group | Facebook asking for suggestions for claiming and getting compensation agreed and distributed. The three aspects we must consider are:

1. What are the practicalities around who receives compensation?
2. Does NRSAG have the register of shareholders as at the date of government acquisition?
3. What is the best way to keep us NRSAG members engaged?

The second lies with the Bank of England's stabilisation powers, specifically MREL (Minimum Requirement for Own Funds and Eligible Liabilities).

Bill Brown has previously provided us with a good commentary on how we got to this situation. The first defence against bank failure is ensuring banks are properly capitalised to withstand losses. But Northern Rock was a liquidity, not a capitalisation, issue: Northern Rock proved that a bank can be solvent yet completely illiquid.

There never should have been a run on Northern Rock and there wouldn't have been if the Bank of England had provided it with funds at the outset. But, because the Bank did not, it exposed the lack of tools needed to manage Northern Rock. This supports our moral claim for compensation.

From the Bank of England's perspective:

- The lack of tools meant serious risks to financial stability.
- The Bank of England was only able to choose between insolvency and bailout.
- It would have liked creditors and shareholders to absorb the losses.

The Bank has now got its resolution programme in place. The Bank requires, by 2022, for every UK bank (and building society) to have a minimum amount of loss absorbing resources. MREL covers both the capital a bank holds in going concern and the capital and debt that can be bailed in if it fails and enters resolution. It might be better next time a Northern Rock happens. It will be for the Bank of England to prove.

In both cases, we have to go back into the past to achieve a better future.

Sources:

UK government's £37 billion bailout of Northern Rock in 2007 pays off (thenationalnews.com).

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10 years since Northern Rock nationalisation | Bayes Business School (city.ac.uk)

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CURRENT UKSA EVENTS

Company meetings

UKSA has a programme of online meetings.
Details of every event are e-mailed to members.

Meetings of UKSA Croydon & Purley Group

Location	**Spread Eagle, High Street, Croydon CRO 1QD** **Meeting dates will appear here.** **Chairman: Harry Braund** harrycb@gmail.com

UKSA BRANCHES – If no contact name or number is given, please contact UKSA office

Branch name	Leader	Administration	Main purpose	Description
London & South East Region	Harry Braund 020 8680 5872 harrycb@ gmail.com	Andrew Girvan 020 8788 1665 agirvan247@btinternet.com	To co-ordinate activities in London and the South-East	Meetings in Croydon three times a year
London company visits	Nick Steiner	Individual meeting organisers	To arrange private meetings with companies	20/30 meetings per year individually arranged
Croydon & Purley	Harry Braund 020 8680 5872 harrycb@gmail.com	Tony Birks 01322 669120 ahbirks@btinternet.com	Social meetings to discuss investment issues	Meetings in Croydon monthly
South West	Peter Wilson 01453 834486 07712 591032	Peter Wilson 01453 834486 07712 591032	To arrange and develop activities for members in the region	Company visits and social events as arranged
North East	Brian Peart 01388 488419	Julian Mole 07870 890973 julian.mole@ btinternet.com	To arrange and develop activities for members in the region	Company visits and social events as arranged
North West	Julian Mole 07870 890973 julian.mole@ btinternet.com	Julian Mole 07870 890973 julian.mole@ btinternet.com	To arrange and develop activities for members in the region	Company visits and social events as arranged
SmartCo	Charles Breese	Charles Breese	Arranging access to 'Smart Companies'	Programme awaiting start-up
Northern Rock Small Shareholders Action Group	Dennis Grainger nrssag@uksa.org.uk	Dennis Grainger nrssag@uksa.org.uk	Pursuing compensation for small shareholders affected by NR's collapse	Lobbying and awareness-raising activities