DUNFERMLINE BUILDING SOCIETY (DBS): AMOUNTS RECOVERABLE BY THE FINANCIAL SERVICES COMPENSATION SCHEME (FSCS) – DETERMINATIONS AND REPORT

Independent valuer – Ian T Burns BA FCA CF

dated 31 July 2012

This Report contains the Determinations and the assumptions and calculations relevant to those Determinations made by Ian T Burns BA FCA CF as independent valuer pursuant to regulation 13 of The Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2010 (SI 2010/2220).

This Report is addressed to HM Treasury and the Financial Services Compensation Scheme and to no other person. This Report was not prepared with the intention that it should be relied upon or used by any person other than HM Treasury and the Financial Services Compensation Scheme or for any purpose other than the purpose for which it was prepared and it may not be relied upon by any person other than HM Treasury and the Financial Services Compensation Scheme or by them for any other purpose.

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A. DETERMINATIONS

I, Ian T Burns BA, FCA, CF, as valuer appointed to exercise functions under section 214D(3) of the Financial Services and Markets Act 2000 (as amended), hereby give notice to the scheme manager and HM Treasury that I have made the following Determinations under section 214(D)(3).

The amounts (in £million) that would have been likely, at the time when the stabilisation power (as provided for in the Banking Act 2009) was exercised, to be recovered by the scheme manager in respect of Dunfermline Building Society if the stabilisation power had not been exercised and Dunfermline Building Society had been unable to satisfy claims against it, and the times at which those amounts would have been likely to be recovered, are:-

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
31 March				79	73	55	45	37	32	28
30 June		30	199	76	69	54	45	37	33	29
30 September				76	68	53	46	37	33	29
31 December	77	110	192	75	68	53	46	37	33	411
Total	**77**	**140**	**391**	**306**	**278**	**215**	**182**	**148**	**131**	**497**
										2,365

The assumptions and calculations relevant to these Determinations are set out in Part B of this determination notice.

This determination notice is given pursuant to regulation 13(5) of The Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2010 (SI 2010/2220).

Words and expressions used in this determination notice shall have the meanings given in the Glossary (contained in Appendix G to this determination notice).

The date of issue of this determination notice is 31 July 2012.

B. REPORT (including assumptions and calculations relevant to the Determinations)

1. INTRODUCTION

1.1. Purpose

I am appointed pursuant to Section 214D of the Financial Services and Markets Act 2000 (as amended) and The Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2010 (SI 2010/2220) to make the determinations contemplated in the legislation arising from the exercise of a stabilisation power under Part 1 of the Banking Act 2009 in respect of Dunfermline Building Society.

My role is set out in more detail in Appendix A to this Report, and requires me to determine the amounts that would have been likely to be recovered by the Financial Services Compensation Scheme, in a counterfactual insolvency of DBS, and the times at which those amounts would have been likely to be recovered. The involvement of the FSCS in a counterfactual insolvency would arise as a result of claims being made on the FSCS by eligible claimants and the FSCS acquiring the rights against the insolvent institution of those persons who are compensated by the FSCS.

The expression "counterfactual insolvency scenario" is used by me in this Report to mean the hypothetical scenario which, under the legislation relating to my appointment as valuer, I am directed to consider. That hypothetical scenario involves DBS being unable to satisfy claims against it, the stabilisation power not having been exercised and the expectation that the FSCS would, in such scenario, have had to step in to satisfy certain claims. The actual scenario is, of course, quite different, in that the stabilisation power was exercised. As a result, much of the business of DBS was transferred to Nationwide Building Society, one particular part of the business of DBS was transferred to a bridge bank, DBS itself was placed into building society special administration, and the FSCS did not have to compensate eligible claimants.

Once I have made the Determinations, I must give to the FSCS (as scheme manager) and HM Treasury ("HMT") notice in writing of any Determinations and the assumptions and calculations relevant to the Determinations. This Report contains the assumptions and calculations relevant to the Determinations I have made.

The Determinations are to be used by HMT in connection with its calculation of payments required to be made by the FSCS in respect of certain expenses incurred in connection with the exercise of the stabilisation power in respect of DBS. I have no role or involvement in such calculations beyond the making of the Determinations.

1.2. Other responsibilities

In addition to my functions under the Contribution to Cost Regulations (see Glossary) I have also been appointed independent valuer for the purposes of performing the functions specified in article 9 of The Dunfermline Building Society Compensation Scheme, Resolution Fund and Third Party Compensation Order 2009. My performance of those functions and my determinations in relation to such matters form no part of this Report.

1.3. Glossary, key dates, etc.

In this Report, all figures have been rounded to the nearest £million, and all year-ends are as at 31 December.

Appendix G to this Report contains a list of words and phrases used in this Report that have the meaning specified in the Glossary.

In this Report a key date is the date on which the stabilisation power in respect of DBS was exercised. That date is 30 March 2009 and is referred to in this Report as the "Relevant Date" or "Administration Inception".[1]

1.4. Sources of information

Since January 2010, when my appointment took effect, I have, together with my consortium partners, met with many parties to obtain views and information relevant to the Determinations. These parties have included: former executives of DBS, the BOE, HMT, the FSA, the BSS Administrators, FSCS, Nationwide and other relevant parties.

Various parties have provided me with information in connection with the performance of my functions. The way in which I must deal with such information is set out in the Contribution to Costs Regulations and summarised in Appendix B to this Report. I have considered carefully all of the information that has been provided to me. I would like to record my gratitude for the co-operation provided to me in the performance of my functions by those parties.

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[1] The stabilisation power was exercised in respect of DBS by the making of a property transfer instrument in respect of DBS which had the effect of transferring certain of DBS's assets and liabilities to Nationwide Building Society. The "transfer time" under that property transfer instrument was 8.00 a.m. on 30 March 2009.

2. IMPLICATIONS OF AN INSOLVENCY OF DBS

In this Section of the Report I set out my assumptions in relation to: the type of insolvency process I consider DBS would have entered (as the result of it being unable to satisfy claims against it) in the counterfactual insolvency scenario; the legal and regulatory implications of this; and the issues the insolvency practitioner who would have been appointed would need to have considered in developing his or her overall strategy in such circumstances.

2.1. Type of insolvency

In making an assumption about the type of insolvency process that DBS would have entered in the counterfactual insolvency scenario, I have considered both the legal structure of the various procedures available to DBS and also the practical considerations of managing the insolvency process, once started, for the best possible return.

The terms under which I am appointed as valuer for the purposes of the Determinations make it clear that it is a feature of the counterfactual insolvency scenario that the stabilisation power had not been exercised. In addition to this I am also required to assume that there would have been no financial assistance provided by either or both of the BOE and HMT.

DBS entered Building Society Special Administration on 30 March 2009 and four partners from KPMG LLP were appointed as its Building Society Special Administrators. BSSA is only available as an insolvency option when the BOE has made or intends to make a property transfer instrument (as defined in Section 33 of the Banking Act). The making by the BOE of a property transfer instrument is the exercise of a stabilisation power under the Banking Act. As the terms of my appointment contemplate that a stabilisation power had not been exercised, BSSA is not an appropriate choice of insolvency process in the counterfactual insolvency scenario.

Having examined the alternative options, I have assumed that in the counterfactual insolvency scenario DBS would have entered administration under Part II of the Insolvency Act 1986 and the relevant Scottish Insolvency Rules.

I have assumed that the administration order would have been made on 30 March 2009.

The remaining options available would have included:

- composition with creditors;
- scheme of arrangement;
- receivership; and
- liquidation or building society insolvency (a similar process).

Composition with creditors or scheme of arrangement would have carried with them substantial difficulties in terms of the procedures themselves and implementing them in an effective manner. Receivership would not have been available, by virtue of the absence of any appropriate floating chargeholders to make the appropriate appointment(s). Liquidation would have made it difficult to engage in any further trading in order to maximise asset realisations, and I have assumed that it would not have been attractive to those initiating the relevant procedure, who would have concluded that it would not lead to an optimal outcome.

2.2. Role and purpose of an administrator

The duties and powers of an administrator are set out in Part II of the Insolvency Act 1986 and associated subordinate legislation. The provisions of schedule B1 of the Insolvency Act do not apply to a building society[1] and would therefore not apply in the counterfactual insolvency scenario.

In the case of DBS I have assumed that in the counterfactual insolvency scenario, an administrator would not have been appointed to achieve the first statutory purpose of an administration provided for in Section 8 of the Insolvency Act 1986, which is the survival of the company, and the whole or any part of its undertaking, as a going concern. I have also assumed that an administrator would not have been appointed for the approval of a voluntary arrangement or the sanctioning of a compromise or arrangement between DBS and its creditors or members. An administrator would therefore have been appointed for the fourth statutory purpose, of achieving a more advantageous realisation of the company's assets than would be effected on a winding up.

I have assumed that the creditors of DBS would have approved an administrator’s proposals on terms that would have permitted an administrator to perform his or her functions in accordance with the strategy identified in this report and also approved their remuneration and expenses.

[1] Enterprise Act 2002 section 249(1)(b)

2.3. Key effects of an administration order

The appointment of an administrator would have had the following immediate effects:

1) A moratorium would have come into force preventing enforcement action by creditors. This moratorium would have provided DBS with the immediate protection necessary to permit an orderly winding down of its operations.
2) The accounts of DBS' depositors would have been frozen, resulting in depositors being unable to withdraw their funds.
3) All liabilities of DBS up to the date of the administration would have become claims against DBS in administration.

2.4. Administration Strategy

2.4.1. Disposal of part or all of the business and assets

An administrator would have considered whether some or all of DBS' business and assets could have been disposed of by means of a going concern sale, i.e. to sell assets and selected liabilities and transfer the appropriate staff and fixed assets, technology and other support facilities as a package, or series of packages, in order to maximise value. Possible courses of action would have included:

- sale of the entire business as a going concern;
- sale of certain assets (and related liabilities) in a series of disposals; and
- closure, and run off of assets.

In reaching his decision about the appropriate course of action in the circumstances, an administrator would have assessed the information prepared preceding DBS' failure. This would have included information that would have been presented to HMT, BOE and to other parties thought capable of taking over DBS' business and assets. Before the actual transfer instruments were made, consideration had been given to ways of dealing with DBS' assets and liabilities. Options had been considered under which part or all of the assets and liabilities of DBS might have been transferred. An administrator of DBS in the counterfactual insolvency scenario would have been aware that a sale of assets (and related liabilities) had not been effected.

An administrator in the counterfactual insolvency scenario would not in my opinion have been able to continue to operate the business of DBS in a conventional sense while a buyer was sought. To do so an administrator would have needed to be able to operate the depositors' accounts in a normal manner from commencement of the administration, a course of action which would not have been open to him. The only circumstance in which I consider an administrator could or might have done so would have been with the support of HMT or the BOE so as to protect the business against the impact of mass depositor withdrawals, minimal new deposits (if any) and the resultant consumption of liquid assets, causing a loss to other creditor groups. Regulatory approvals would also require to have been obtained.

I am required to assume that in the counterfactual insolvency scenario there would have been no support from HMT and/or the BOE.

The lack of HMT or BOE support would in addition have effectively precluded the transfer of part or all of the deposit book, because of the need to balance the liabilities transferred with suitable assets, and the need to deal with all creditors equally, as far as possible.

I have accordingly assumed that an administrator would have closed the branch network on appointment, made most staff redundant with immediate effect and only retained those (primarily head office staff) who would have been of immediate benefit to the administration.

2.4.2. Realisation strategy (absent a going concern sale)

An administrator has two basic strategies in respect of any given asset class:

- to seek an early sale, soon after his appointment, to minimise holding costs; or
- to hold the asset with a view to an improved overall realisation in the longer term from income and / or capital returns.

I have assumed that, in the counterfactual insolvency scenario, an administrator would have disposed of as many of DBS' assets as was both appropriate and cost effective during the early stages of the administration, to reduce administrative and insurance costs associated with them and enable earlier distributions to creditors, with the exception of the preferred strategy for realising DBS' mortgage assets, and those assets that an administrator would have required for the purposes of managing DBS' affairs.

In light of the significant uncertainty in the banking sector and the wider economy at the Relevant Date, and the low rates of interest earned on part of DBS' mortgage book (e.g. a substantial portion of its Social Housing portfolio), I have assumed that any offers for the main constituent parts of the mortgage book that might have been made at or around the Relevant Date are likely to have been at a significant discount to book value and that an administrator would have chosen to run off the main part of the loan books over the course of the administration, selling any residual balances at its conclusion.

During that run-off period, an administrator would have kept the costs of continuing DBS' operations and his own costs under review, and assessed these against the benefits in terms of the realisations from loan interest received and mortgage repayments and prepayments, to determine at what point the discounted receipts from a sale of the rump of the loan books gave a better result than continuing to run off and incur the related costs. In modelling the return from the administration with this issue in mind, I have assumed that the run-off of the mortgage portfolios of DBS would have taken place over ten years, with a sale of the balance at the end of that period.

In assuming a run-off strategy for DBS' mortgage assets, I have taken account of the difficulty of developing robust anticipated sales prices, in the light of the lack of contemporaneous transactions for the sale of similar loan books, and the fact that the BSS Administrators of DBS have adopted a similar strategy in realising DBS commercial and bought-in loan book assets.

The results from running off the loan portfolios, and the interest income derived during this process, would have been the single biggest determinant of the outcome from the administration of DBS in the counterfactual insolvency scenario.

2.5. Distributions to creditors - the statutory framework

Any distributions made to creditors from these asset realisations would have needed to be made in compliance with the statutory order of priority of claims in the counterfactual insolvency scenario, including the impact of statutory interest.

2.5.1. Order of priorities

I have considered and sought advice concerning the order of priority of claims arising in the counterfactual insolvency scenario. I have also had regard to the directions given by the Court of Session to the BSS Administrators in August 2011 and applied those directions in the counterfactual insolvency scenario.

Expenses of the administration

Expenses of the administration would have fallen to be repaid in priority to all other claims. I have assumed that an administrator would have had sufficient funds to meet all expenses of the administration. The surplus would have been available to pay to creditors in accordance with the order of priority of claims provided by applicable law.

Creditor Priorities

There would have been a number of classes of creditor of DBS in the counterfactual insolvency scenario.   I have assumed that certain of the creditors' claims would have been deferred or subordinated both in respect of the principal sum claimed and interest thereon. I have relied on the directions of the Court of Session in the application of this principle, as described further in Section 2.5.3.

In particular there would have been two classes of depositors with DBS. The first class are those persons who had simple deposits with DBS (the non member depositors). The second class are those persons who had funds deposited with DBS that resulted in such persons being shareholding members as defined in Rule 4(1) of the Rules of DBS (the shareholding members).

The legal rights of shareholding members and non-member depositors of DBS are different and their claims in the counterfactual insolvency scenario of DBS would have had a different ranking. I have summarised the rights of the different categories of creditor in the counterfactual insolvency scenario in Table 2.5.1.

Table 2.5.1: Order of priorities

	Category	Principal claims included:
1	Preferential Creditors	Former employees for arrears of pay (capped at £800) and holiday pay
2	Ordinary Creditors	Depositors with non-share accounts ("the non-member depositors") Trade creditors of DBS Tax liabilities Employment liabilities (other than the first £800 of any arrears of pay and all accrued holiday pay)
3	Statutory Interest	Payable at 15% per annum on preferential and ordinary claims
4	1st Subordinated Creditors	Depositors with share accounts ("the shareholding members")
5	Statutory Interest	Payable at 15% per annum on 1st Subordinated claims
6	2nd Subordinated Creditors	£50m subordinated loan notes (“the Note holders”)
7	Statutory Interest	Payable at 15% per annum on 2nd Subordinated claims

2.5.2. Claims of FSCS in the administration

I am required to assume that, in the counterfactual insolvency scenario, DBS would have been unable to satisfy claims against it. As a result of this, DBS would have been “in default” for the purposes of the FSCS, which would have had the effect of entitling eligible claimants to be compensated by the FSCS.

Pursuant to the terms of the FSCS, the payment of compensation by the FSCS to an eligible claimant is conditional on the eligible claimant assigning the whole of his or her rights against the relevant institution to the FSCS. This means that the FSCS would have become a creditor in respect of the full amount of the deposits of eligible claimants in place of those eligible claimants.

I have assumed that there would have been two classes of persons eligible for compensation by the FSCS in the circumstances of the counterfactual insolvency scenario of DBS. The first class are the non member depositors and the second class are the shareholding members.

Accordingly, the FSCS would, in a counterfactual insolvency, stand in the shoes of both non-member depositors and shareholding members, and would be repaid in respect of each of these classes of creditors from funds realised from the administration in the order of priority as set out in Table 2.5.1 above.

Not all depositors with DBS would have been “eligible claimants” under the FSCS. For example, local authority depositors would not have been entitled to compensation from the FSCS.

Further information about my assumption about the different claims of the FSCS in the counterfactual insolvency scenario is given in Appendix C to this Report.

2.5.3. Directions from the Court of Session

Following my appointment it was identified that the law relevant to my Determinations was not clear in certain respects and that the issues were material to my Determinations. The issues arising also affected the functions of the BSS Administrators. The BSS Administrators applied to the Court of Session in Edinburgh in 2011 seeking directions in relation to certain legal issues including the order of priority of claims.

The first direction concerned the respective ranking of the debt due under the £50 million 6 per cent Subordinated Notes due 2015 ("the Notes") and the liabilities DBS owed to the shareholding members. The Notes were held to be subordinated to the liabilities to the shareholding members and therefore ranked after the shareholding members in respect of both principal and interest.

The second direction related to the application of Section 74(2)(f) of the Insolvency Act 1986 and the respective ranking of the shareholding members in competition with ordinary creditors of DBS. The court held that Section 74(2)(f) applied by necessary implication to the administration of a building society. The shareholding members therefore rank after the ordinary creditors of DBS, including non – member depositors.

The Court also directed that s189 applied to a building society in administration or BSSA and that on a correct interpretation of Rule 4.66 of the Scottish Insolvency Rules 1986 statutory interest must be paid on the ordinary, unsecured and unsubordinated liabilities of DBS before any payment can be made to the subordinated creditors i.e. the shareholder members and the Note holders.

While I was not a party to the application to the Court, I was given the opportunity to contribute to the application and the Court was made aware of my interest and the relevance of the directions of the Court to my functions. I have relied on the directions of the Court for the purposes of my Determinations.

2.5.4. Post administration interest

Interest would have accrued on all claims admitted by an administrator in the counterfactual insolvency scenario between the date of commencement of the administration and the date of payment, at the statutory rate of 15% per annum.

To the extent that interest was payable, it would have ranked behind payment of the principal debt to which it relates. If there were insufficient funds to pay interest in full to the relevant creditors, the amount available to pay interest would have been shared *pari passu* amongst them.

The impact of statutory interest on amounts payable to the various classes of DBS' creditors in the counterfactual insolvency scenario is described in Sections 3 – 6 of this Report.

2.6. Developing an outcome statement

The calculation of the outcome from a counterfactual insolvency scenario of DBS is obtained through:

1) assessing an administrator's choice of asset realisation strategy, either by way of immediate sale or run off. This is described in Section 2.4.2 above.
2) estimating the impact of insolvency on opening net assets. This is described in Section 3 below, and involves:
   - establishing the net cash inflows arising from the application of an administrator's chosen strategy for each asset or class of asset, and assessing the net income / costs of the administration. This is described in Section 4 below and involves the estimation of:
     i) the realisation of (and losses on) the 'capital' element of the assets, whether sold immediately or run off;
     ii) the anticipated impairments to asset values arising over the run-off period;
     iii) the income generated from the assets during the run-off period; and
     iv) the costs of the run-off and the expenses of the administration, and as a result the cash available at each period end for distribution.
   - identifying and quantifying DBS' liabilities and their respective priorities (described in Section 5 below); and
   - distribution of surplus funds to the creditors whose claims have been admitted in accordance with the appropriate order of priority, including the application of statutory interest where applicable (described in Section 6 below).

This is the approach that I have followed for the purposes of making my Determinations.

3. IMPACT OF ADMINISTRATION: SUMMARY

3.1. Introduction

In this section I summarise the effects of DBS entering into insolvency in the manner described in Section 2 above. I begin by summarising DBS' opening net assets, followed by an overview of the adjustments I consider necessary and my assessment of the impact of subsequent trading, in each case arising from the assumed actions of an administrator in the counterfactual insolvency scenario. Further details are set out in Sections 4 and 5 below, as is the impact on amounts receivable by an administrator and payable to the various creditors of DBS, including the FSCS, in the counterfactual insolvency scenario.

3.2. Opening balance sheet

The opening balance sheet of DBS immediately prior to insolvency is summarised in Table 3.2.

The information on which this is based has been extracted from the books and records of DBS, and related to the period immediately prior to the exercise of the stabilisation power.

Table 3.2: Opening balance sheet

Assets		**Liabilities**	
Treasury/liquid assets	776	Deposits	3,096
Mortgage loans	2,380	Taxation	(11)
Other assets	40	Other creditors	3
Prepayments and accrued income	27	Accruals and deferred income	2
Fixed assets	14	Pensions	6
		Subordinated debt	53
			3,149
		Reserves	**88**
Total	**3,237**		**3,237**

3.3. Adjustments

In an insolvency, in my experience, it is rare for the values of assets and liabilities to match those contained in an organisation's going concern balance sheet.

DBS' balance sheet as at 30 March 2009 summarised above was prepared on a going concern basis, and as such contained no provision for the effects of an insolvency of DBS on its assets and liabilities. I summarise in Table 3.4 below the adjustments that I have calculated require to be made to the assets and liabilities of DBS in the counterfactual insolvency scenario.

More detailed information about my calculations of the adjustments to the value of assets and liabilities, the income from the run-off of the mortgage loans and the costs of administration and statutory interest are to be found in later Sections and in the Appendices to this Report.

3.4. Impact of Administration – overview (net assets basis)

Had DBS entered insolvency on the Relevant Date, I have calculated that the outcome of the administration and run-off strategy would have been as summarised in Table 3.4 and would reflect:

- its "going concern" opening balance sheet as at 30 March 2009;
- losses on the principal / capital value of assets shown in the opening balance sheet as a consequence of the administration, together with losses arising in the mortgage book over the run-off period;
- adjustments to DBS' liabilities as a consequence of the administration;
- interest and other income from pursuing a run-off strategy, less expenses of the administration;
- bad debts that arise over time from trading; and
- the impact of statutory interest accruing in the administration.

Table 3.4: Adjusted net assets

	Section Ref	Book Value	Adjustment	Estimated to Realise
Assets		3,237	(511)	2,726
Liabilities	5.1	(3,149)	(60)	(3,209)
Surplus/(Shortfall) assets basis		**88**	**(571)**	**(483)**
Surplus/(Shortfall) brought down				(483)
Income during run off	4.3.2			649
Costs and expenses	4.3.3			(133)
Surplus/(Shortfall) before Statutory Interest				**33**
Surplus/(Shortfall) brought down				33
Statutory Interest Accrued	3.6.1			(2,175)
Surplus/(Shortfall) after Statutory Interest				**(2,142)**

Before considering the income from DBS' assets during the administration, I have calculated that there would have been a shortfall of £483 million to its creditors. However, I calculate that the impact of run-off income (net of expenses) would have more than made good this shortfall, generating a surplus of £33 million before accruing for statutory interest on admitted creditor claims.

Assumptions and calculations I have made in respect of each of these items are as set out in the relevant sections of this Report identified in Table 3.4.

3.5. Impact of administration – overview (time basis)

The information in Section 3.4 can be alternatively summarised following the timelines over which the above adjustments are likely to arise, as set out in Table 3.5.

Table 3.5: Opening balance sheet

Adjustments incurred in opening period	Section Ref	Book Value	Adjustment	Estimated to Realise
Assets	4.2	3,237	(106)	3,131
Liabilities	5.1	(3,149)	(60)	(3,209)
Surplus/ (Shortfall):		**88**	**(166)**	**(78)**
Income over the administration:				
Bad debts incurred during run-off	4.3.1			(405)
Income generated over Administration	4.3.2			649
Costs and expenses	4.3.3			(133)
				111
Surplus/ (Shortfall) before Statutory Interest				**33**

Sections 4 and 5 of this Report follow this analysis, which is presented on the basis that losses on the run off of the mortgage book are classified as a component of income over the administration period.

3.6. Effect of Statutory Interest and Order of Priority

While the above presents a useful overall picture, the order of priority of payments to creditors set out in Section 2.5.1 would have the effect that some classes of creditor would have received their entire entitlement plus statutory interest, while others would have faced a shortfall, and some no payment at all.

3.6.1. Analysis of statutory interest

On the basis of the outcome of the administration in the counterfactual insolvency scenario summarised in Tables 3.4 and 3.5 and described in more detail in Sections 4 to 6 of this Report, and applying the order of priorities set out in Section 2.5.1 above, I have calculated that the statutory interest of £2.175 billion included in Table 3.4 would have accrued to creditors as set out in Table 3.6.1.

Table 3.6.1: Analysis of statutory interest

	£m
Paid in respect of preferential and ordinary creditor claims	113
Accrued in respect of 1st and 2nd subordinated creditors	2,062
	2,175

3.6.2. Asset shortfall

The effects of this are set out in Table 3.6.2, which adjusts the deficiency of assets before statutory interest as described in Section 3.4 above by the impact of the statutory interest that becomes payable as described above:

Table 3.6.2: Adjusted assets prior to unpaid interest

	Section Ref.	£m
Surplus before impact of priority and statutory interest	3.4	33
Statutory interest paid ahead of subordinated creditor claims in respect of preferential and ordinary claims	6.1	(113)
Shortfall of assets to meet subordinated creditor claims		(80)

On the basis of the above calculations, there would have been a net shortfall against creditor claims, prior to the consideration of accrued but unpaid statutory interest, of £80 million.

As a result, I have calculated that no statutory interest in respect of either 1st subordinated claims (including claims by the FSCS in relation to member deposits) or 2nd subordinated claims (being the subordinated debt holders) would be payable.

3.7. Impact of administration – detail

Further information and explanations about my assessment of the impact of the administration in the counterfactual insolvency scenario is provided in:

- *Section 4;* which sets out my calculations of amounts likely to be realised from DBS' opening balance sheet assets, income earned over the course of the administration and related costs;
- *Section 5;* which sets out my calculations of the adjusted liabilities of DBS in the administration, in order of priority; and
- *Section 6;* which sets out my calculations of the allocation of assets realised among the various classes of creditor (including the FSCS), having regard to the order of priorities and the impact of statutory interest.

4. ASSET REALISATIONS AND ADMINISTRATOR'S RECEIPTS (NET OF COSTS)

4.1. Realisation of assets

I have described the strategy that I have assumed an administrator would have followed in the counterfactual insolvency scenario in Section 3) above. In this Section I set out my calculations of the level of realisations that would have been achieved from DBS' assets, and which would have been available for distribution.

The realisations would, in general terms, have taken two forms:

- the conversion of the underlying balance sheet assets into cash over the life of the administration; and
- other income, represented almost solely by interest income deriving from those assets that are subject to a run-off strategy (principally the loan books).

I have described further the relevant asset classes and my assumptions about realisation strategies and expected recoveries at Appendices D and E of this Report.

4.2. Summary of Realisations from Balance Sheet Assets - opening

I have summarised in Table 4.2 my calculation of the likely recoveries that would have been made from the sales of those of DBS' assets that would have occurred in the short-term, which I have assumed would encompass the first three years of the administration only.

I have not, in this analysis, taken account of any potential impairments to the mortgage book. Such impairments are dealt with as part of income during run-off, and accordingly do not give rise to any adjustments at this stage.

Table 4.2: Asset recoveries

Balance sheet heading	Book Value (30 March 2009)	Adjustments	Estimated to Realise
Treasury/liquid assets	776	(47)	729
Mortgage loans	2,380	-	2,380
Other assets	40	(34)	6
Prepayments and accrued income	27	(27)	0
Fixed assets	14	(6)	8
Corporation Tax	0	8	8
Total assets	**3,237**	**(106)**	**3,131**

Table 4.2 shows an assumed shortfall against assets of £106 million, and reveals assets available for distribution prior to bad debts of £3.131 billion. Further details of the assets involved, realisation strategies and expected recoveries are set out in Appendix D to this Report

4.3. Income during the run-off

As described in Section 2.4.2 and detailed in Appendix E to this Report, I have assumed that, with limited exceptions, an administrator in the counterfactual insolvency scenario would have run off the loan books over a ten-year period. From this activity an administrator would have:

- collected cash on the assets run off;
- assumed the burden of any attendant bad debts;
- received interest income on the loan book, as well as on any deposits held in the administration bank accounts. In addition, he would have earned a small amount of fee and commission income in the early years, and interest income on financial assets prior to maturity; and
- borne all necessary costs and expenses.

4.3.1. Bad debts

As described in more detail in Appendix E to this Report, the application of the assumptions I have made leads me to the view that significant adjustments to mortgage asset carrying values as stated in the opening balance sheet would have been necessary, both in order to recognise required additional impairments over the life of the administration, and the anticipated loss on sale of the remaining assets after ten years at the close of the administration. I calculate that these adjustments would have been £405 million, the bulk of which would relate to impairments of assets during their run-off.

4.3.2. Interest income

I have calculated interest income throughout the period by:

- establishing those assets on which interest is likely to be received – i.e. on assets net of impairments, calculated on the bases described in Section 3; and
- applying to these balances interest rates based on those specified in individual loan agreements. Where variable interest rates are specified, I have based the relevant calculations on the sterling LIBOR futures swap curve at Administration Inception.

I calculate the income arising from these sources during the administration would have totalled £649 million.

4.3.3. Costs and expenses

Costs and expenses would have included:

- the direct costs of an administrator's activities in relation to the assets of DBS; and
- the expenses of the administration, including the fees of an administrator and his advisers.

Costs of trading on / running off the loan books

An administrator would have needed to retain a number of key staff to manage the run-off of loan portfolios, including those with the requisite skills in customer relationship and credit management. An administrator might have needed to recruit fixed-term contractors or new staff during the run-off period to replace leavers and to provide suitable remuneration structures to incentivise staff. I have calculated the overall operating costs of the loan book run-off against available benchmarks, and also produced estimates of costs on a bottom-up basis.

I calculate the total of the above expenses would be £41 million.

Administration expenses

I have also calculated the costs of an administrator in undertaking his duties and implementing the strategy described elsewhere in this Report. These costs would have included those of advisers, including legal, corporate finance, treasury and property specialists, and an administrator's own fees. In making my calculation I have made reference to the costs incurred in the actual scenario of the insolvency of DBS as a source of comparative data for certain elements of the cost calculations as well as other bases of calculations.

I calculate total administration expenses over the ten year period of the administration would have been £92 million.

This results in overall costs described in this Section 4.3.3 of £133 million over the period of the administration in the counterfactual insolvency scenario.

4.4. Summary – income during the run-off

Table 4.4 summarises the income from the run-off using the assumptions in this Report.

Table 4.4: Income during run-off

Bad debts incurred	(405)
Interest income	649
Expenses	(133)
	111

4.5. Total realisable value of DBS' assets

The combination of the proceeds from asset realisations and interest income, less costs and expenses, over the administration period, would I calculate have resulted in £3.242 billion of assets available for distribution, as summarised in Table 4.5.

Table 4.5: Assets available for distribution

	Section Ref	£m
Proceeds from realisation of underlying assets	4.2	3,131
Income from administrator's trading	4.4	111
Available to distribute		**3,242**

4.6. Timing of Cash flows

I calculate that the assets available for distribution described in Section 4.5 would have arisen over the period in the manner set out in Table 4.6.

Table 4.6: Distributable assets, annual

Year	1	2	3	4	5	6	7	8	9	10	Total
Proceeds from asset realisations	600	347	313	241	221	167	142	113	104	478	2,726
Post-administration trading (net of costs)	46	80	77	68	59	51	44	37	30	24	516
Assets available for distribution	**646**	**427**	**390**	**309**	**280**	**218**	**186**	**150**	**134**	**502**	**3,242**

The bases (including assumptions) on which these cash flows have been allocated across the administration period are described in Section 4.3 and Appendices D and E of this Report.

5. LIABILITIES OF DBS IN ADMINISTRATION

5.1. Additional liabilities

In much the same way that accounting values of assets on a going concern basis may not match their realisable value in an insolvency, I have assumed that the quantum of liabilities of an insolvent entity would also be subject to change as a result of new claims being generated (for example from termination of contracts) and other claims increasing as potential future costs / contingent liabilities are crystallised.

Table 5.1 sets out DBS' opening liabilities and the adjustments I calculate would have occurred in the counterfactual insolvency scenario.

Table 5.1: Adjusted liabilities

Balance sheet heading	Opening Book Value (30 March 2009)	Adjustments	Restated
Deposits: shareholder member share accounts: FSCS	(2,268)	0	(2,268)
: other	(49)	0	(49)
Deposits: non member share accounts: FSCS	(108)	0	(108)
: other	(671)	0	(671)
	(3096)	0	(3096)
Taxation	11	(12)	(1)
Other creditors	(3)	0	(3)
Accruals and deferred income	(2)	0	(2)
Pensions	(6)	(32)	(38)
Subordinated debt	(53)	0	(53)
Claims arising on insolvency	0	(16)	(16)
Total liabilities	**(3,149)**	**(60)**	**(3,209)**

Further explanation of the above adjustments is set out in Appendix F to this Report.

I calculate that the total amount of the FSCS related creditor claims at the Relevant Date would have amounted to £2.376 billion, represented by £108 million of non-member deposit related claims (which form part of the ordinary creditors of the administration) and £2.268 billion in relation to shareholder member deposit related claims, which rank behind payments of principal and statutory interest to preferential and ordinary creditors.

5.2. Priority

I have assumed that the various claims against DBS in the counterfactual insolvency scenario would have been subject to the order of priority set out in Table 5.2 (see also Section 2.5.1 and Table 5.1).

Table 5.2: Adjusted liabilities – priority

Category	FSCS	Non-FSCS	Total
Preferential & Ordinary	108	731	839
1st Subordinated	2,268	49	2,317
2nd Subordinated		53	53
Total	**2,376**	**833**	**3,209**

In Table 5.2:

- "1st Subordinated" claims relate to FSCS and other shareholder member account deposits;
- "2nd Subordinated" claims relate to subordinated debt balances (including accrued interest to date of insolvency); and
- "Preferential and Ordinary" claims comprise all other liabilities, including non-share account deposits.

6. DISTRIBUTIONS

6.1. Overall Position

I calculate that the assets available for distribution of £3.24 billion set out in Table 4.5 would have fallen to be distributed as set out in Table 6.1, over the period of the administration, having regard to the liabilities set out in Table 5.2, and applying the order of priorities set out in Section 2.5.1.

Table 6.1: Distributions - summary

	Section Ref	£m
Available to distribute	4.5	3,242
Preferential and ordinary creditors paid	5.2	(839)
Statutory interest paid to preferential and ordinary creditors	3.6	(113)
Available to 1st Subordinated		2,290
Paid to 1st Subordinated		(2,290)
Available to 2nd Subordinated		0

6.2. Return to subordinated creditors

In Table 6.2 I compare the amounts payable to 1st and 2nd subordinated creditors as set out above with their adjusted claims, prior to the impact of statutory interest.

Table 6.2: Returns to subordinated creditors

	Claim	Paid	Shortfall
1st Subordinated – FSCS	2,268	(2,242)	26
1st Subordinated – Other	49	(48)	1
1st Subordinated – Total	2,317	(2,290)	27
2nd Subordinated - £50m Subordinated Floating Rate Notes	53	0	53
			80

As noted in Section 3.6, the application of statutory interest in such an administration would have had a different impact on different classes of creditors. In the case of the counterfactual insolvency scenario of DBS, as set out above, this would have had the effect that:

- all preferential and ordinary creditors – including the FSCS creditor of £108 million relating to non-member accounts noted in Table 5.1 and Table 5.2 – would have been paid in full, both as to principal and statutory interest;
- 1st subordinated creditors – including the FSCS creditor relating to member deposits – would have received slightly less than 100p in the pound in respect of their principal, and no statutory interest; and
- 2nd subordinated creditors – the subordinated loan note holders would receive neither principal nor interest.

6.3. Overall considerations – quantum / timing of distributions

The distribution process in an insolvency requires certain statutory formalities to be complied with, and therefore there will be a maximum frequency at which an administrator can distribute in practice. In addition to these statutory formalities there are other relevant practical considerations such as the ability to provision accurately for short and medium term future receipts and payments, the volume of claims that would not have been submitted or agreed, and the logistics of making payments.

I have, therefore assumed that there would have been less frequent distributions in the first three years of the counterfactual insolvency scenario. Once the claims of ordinary creditors and the related interest had been settled in full, I would expect an administrator to have been able to increase the distribution frequency, since the vast majority by value of the 1st subordinated claims would be due to the FSCS, thereby limiting the risk to the administrator.

I have also assumed that an administrator would not have been in a position to make a distribution during the first 9 months after his appointment. For the following two years I have assumed that distributions would have taken place every six months and thereafter four times a year at equal intervals.

Before making a distribution an administrator would have needed to make an assessment of the extent to which funds in hand could be distributed and to calculate a suitable reserve to meet unforeseen contingencies, which might include meeting ongoing costs of the collection operation in the event of, for example, a dramatic reduction in the collectability of the mortgage books due to macro-economic changes. The level of reserve would have been a matter of professional judgement for an administrator and would be subject to a number of factors.

The level of reserve I have assumed equates to between 7.5% and 20% of funds available.

6.4. Distributions – quantum, recipients

On the basis of the above assumptions and calculations, and having regard to the assets available for distribution set out in Section 4.5 and the order of priority, I calculate that the assets available for distribution would have been distributed annually as set out in Table 6.4:

- firstly, to the preferential and ordinary creditors in respect of principal (“Ords” in Table 6.4 overleaf; total: £839 million);
- secondly, to the preferential and ordinary creditors in respect of statutory interest, at 15% per annum (“Interest”; total: £113 million); and
- the balance to the 1st subordinated creditors, both the FSCS and third parties (“Deferred”; total: £2.29 billion).

Table 6.4: Distributions

Year	Section Ref	1	2	3	4	5	6	7	8	9	10	Total
Asset receipts	4.6	646	427	390	309	280	218	186	150	134	502	3,242
Retention b/f		0	48	25	16	12	7	5	6	6	6	
Available for distribution		**646**	**475**	**415**	**325**	**292**	**225**	**191**	**156**	**140**	**508**	
Distributions												
Ords - FSCS		77	31									108
-other		521	210									731
		598	241									839
Interest - FSCS			15									15
-other			98									98
			113									113
Deferred -FSCS			94	391	306	278	215	182	148	131	497	2,242
-other			2	8	7	7	5	3	2	3	11	48
			96	399	313	285	220	185	150	134	508	2,290
Total distributed		**598**	**450**	**399**	**313**	**285**	**220**	**185**	**150**	**134**	**508**	**3,242**

Year	1	2	3	4	5	6	7	8	9	10
Total distributed	598	450	399	313	285	220	185	150	134	508
Retention	48	25	16	12	7	5	6	6	6	0
Available for distribution	**646**	**475**	**415**	**325**	**292**	**225**	**191**	**156**	**140**	**508**

6.5. Returns to FSCS

As noted in Section 5.2, the total opening FSCS creditor claim would have been £2.376 billion, comprising £2.268 billion of 1st subordinated debt and £0.108 billion of ordinary debt.

The application of the above assumptions and calculations and having regard to the order of priority would have resulted in total annual distributions to the FSCS, made up of payments of principal on its ordinary creditor claim (“Ordinary”), statutory interest on its ordinary creditor claim (“Interest”), and part-payment of its deferred creditor claim (“Deferred”) of £2.365 billion, as set out in Table 6.5.

Under these assumptions and calculations, the FSCS would have suffered a net shortfall of £11 million (taking into account statutory interest paid to the FSCS) on its combined ordinary and deferred creditor claims.

Table 6.5: Returns to FSCS

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Ordinary	77	31									108
Interest		15									15
Deferred		94	391	306	278	215	182	148	131	497	2,242
Total	77	140	391	306	278	215	182	148	131	497	2,365

As noted in Section 6.3, I have assumed that a first distribution would have been made nine months after Administration Inception, i.e. on 31 December 2009, with subsequent distributions at half-yearly intervals for the next two years (i.e. until 31 December 2011) and quarterly thereafter.

Details of these recoveries, by quarter, are set out in Part A of this Report.

Appendix A: Outline of my role

I was appointed pursuant to The Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2009 ("Former Regulations") to carry out the independent valuation functions specified in the Former Regulations in relation to Dunfermline Building Society. Before completing my functions under the Former Regulations, HMT made The Financial Services and Markets Act 2000 (Contribution to Costs of Special Resolution Regime) Regulations 2010 which revoked the Former Regulations. Pursuant to the Contribution to Costs Regulations, my appointment is to be treated as an appointment to perform the functions specified in section 214(D)(3) of the Financial Services and Markets Act 2000 (as amended).

My functions, for this purpose, require me to determine:

1) the amounts that would have been likely, at the time when the stabilisation power was exercised in relation to DBS, to be recovered by the FSCS in respect of DBS if the stabilisation power had not been exercised and DBS had been unable to satisfy claims against it; and

2) the time or times at which those amounts would have been likely to be recovered.

The Determinations are one of the matters that HMT must have received before HMT determines the limit of the amount of special resolution regime payments that HMT can require to be made by the FSCS.

Pursuant to the Contribution to Costs Regulations, I am permitted to do anything necessary or desirable for the purposes of or in connection with making the Determinations. I am also given power to apply to the court for an order requiring the provision of information reasonably required for making the Determinations. I have not made any such application to the court.

Once I have made the Determinations, I must give to the FSCS and HMT notice in writing of the Determinations and the assumptions and calculations relevant to the Determinations. This Report constitutes that notice.

If the FSCS or HMT are dissatisfied with the Determinations, either may require me to reconsider these by making a request to me in writing within three months of the date of this Report setting out the reasons for disputing either or both the Determinations.

Appendix B: My approach to disclosure of information

Many persons have provided me with information in connection with the performance of my functions in relation to the Determinations. The extent to which I can disclose in this Report information that I have received is set out in the Contribution to Costs Regulations.

The Contribution to Costs Regulations provide that I must not disclose information obtained by me for the purpose of the Determinations without the consent of the person from whom the information was obtained and, if different, the person to whom such information relates.

The prohibition on disclosing information without consent does not apply if and to the extent that I consider it necessary to disclose such information for the purposes of exercising the functions of my office. Before disclosing any such information without consent, I must have regard to the need to exclude from disclosure (as far as practicable):

1) commercial information the disclosure of which might significantly harm the legitimate business interests of the person to whom it relates;
2) information relating to the private affairs of an individual, the disclosure of which might significantly harm the individual's interests; or
3) any information the disclosure of which would be contrary to the public interest.

I have therefore, where required, obtained the consent of the person from whom information was obtained (or if different, the person to whom such information relates) before including such information in this Report. Where such consent has not been obtained, I have had regard to the factors set out above in deciding whether to include that information in this Report.

I have not included in this Report certain information which I consider not to be material in order for the FSCS or HMT to understand the assumptions and calculations in this Report.

Appendix C: Rights of recovery of the FSCS

I have assumed, for the purposes of my Determinations, that the FSCS would, at the Relevant Date, have had the right to recover from DBS the full amount of the deposits held with DBS at that time by persons (described as "eligible claimants") who would have been entitled to compensation under the rules governing eligibility under the Financial Services Compensation Scheme.

I have made this assumption because of the following requirements of the legislation and COMP:

- I am required to determine the amount that would have been likely to have been recovered by the FSCS in respect of DBS if the stabilisation power had not been exercised and DBS had been unable to satisfy claims against it. In these circumstances, the FSCS would have incurred expenses in making compensation payments to eligible claimants in accordance with COMP.
- Pursuant to COMP 7.2 .1R, the FSCS must make any payment of compensation to a claimant, in respect of a protected deposit (as defined in COMP), conditional on the claimant, insofar as able to do so, assigning the whole of his rights against the relevant person (in this case DBS) to the FSCS.

I have therefore assumed that (i) eligible claimants would have assigned the whole of their rights against DBS to the FSCS (having received no evidence that this would not have been the case); and (ii) the FSCS would, therefore, have been entitled to claim for the full amount of the protected deposits from DBS.

Under COMP 7.2.3AR the FSCS is required to pay some of its recoveries to the claimant, such a payment being referred to in COMP as a "top-up payment". For the purposes of my Determinations, I have not had regard to any "top-up payment" and have calculated the recovery of the FSCS from DBS without any deduction of any "top-up payment" that may have been required to have been made by the FSCS following receipt by the FSCS of any recoveries.

The amount receivable by the FSCS in the counterfactual insolvency scenario would have been affected by its ranking in the order of priorities for the payment of creditors. This issue is considered in Sections 2.5.1 and 2.5.2 of this Report.

Appendix D: Asset realisations – short term

As noted in Section 2.4.2 of this Report, I have assumed that, other than the loan books, the majority of DBS' assets would have been realised by an administrator during the first three years of the administration in the counterfactual insolvency scenario. Further details are set out below.

Treasury / liquid assets

For all treasury / liquid assets, I have assumed that they would convert to cash on maturity, at face value, as early settlement might have resulted in material transaction / mark-to-market discounts. No adjustment to the opening balance sheet is thus required in respect of these assets, with the exception of the impact of related derivative instruments, which is considered below.

Other Assets

The category of "Other assets" comprises inter company balances due to DBS from its four subsidiary companies and any residual value in the shareholdings of those companies after settlement of intercompany balances. These assets had a book value of £40 million at Administration Inception. One of the subsidiaries was dormant and, in the actual administration, has been struck off with no return to DBS. The remaining three subsidiaries had the following purposes:

- To develop and hold the investment in IT systems used by DBS;
- To administer a distinct portfolio of social housing loans; and
- To hold an interest in the head office building.

The largest of the individual balances (some £37 million) relates to the IT development company. While the software and systems would be useful to an administrator in conducting a run-off, I have assumed that the systems would have had no realisable value in the context of an insolvency of DBS in the counterfactual insolvency scenario.

Realisation proceeds have been calculated on the basis of experience of realisable values of similar assets in insolvency scenarios, an assessment of the balance sheets of the subsidiaries and discussions with various parties with knowledge of the subsidiaries' affairs and of the IT system developed.

I have calculated that approximately £6 million of cash receipts would have been recovered in respect of such assets, resulting in a £34 million adjustment, as shown in Table 4.2 in this Report.

Derivative contracts

I have assumed that, on administration in the counterfactual insolvency scenario, all derivative contracts would have been closed out to the extent possible under the relevant documentation, a strategy also adopted by the BSS Administrators. On DBS' mark to market ("MTM") valuations, I have calculated that this would have resulted in receipts of £54 million and payments of £75 million.

In addition to MTM close out valuations, I have assumed that there would have been further discounts relating to the "forced sale" nature of the close-outs, and transaction costs would have been incurred.

I have calculated that the combined impact of these adjustments would have resulted in a net payment – or balance sheet loss – of £47 million at or soon after the Relevant Date. This adjustment has been allocated to the "Treasury/liquid assets" line of Table 4.2 in this Report, although the instruments themselves were off-balance sheet at the Relevant Date.

Prepaid and accrued income

The majority of prepayments and accrued income relate to derivative contracts of DBS. As I have assumed that these would have been closed out on or soon after Administration Inception, I have assumed that no value would have been realisable against these assets, resulting in my calculation of an opening balance sheet provision of £27 million.

Fixed assets

Freehold properties have been valued with reference to a valuation conducted in early 2009 together with assumed discounts for forced sale.

Leasehold assets are considered further in conjunction with their attendant financial commitments in Appendix F of this Report, which deals with adjusted liabilities.

Assumptions in relation to other tangible assets have been made according to general experience of the market and based on comments made in relation to the quality and condition of the assets during the course of my enquiries.

The application of these assumptions results in my calculation of anticipated cash receipts of £8 million, and a consequent loss of £6 million against book value.

Timing

I have assumed that all assets not required for the ongoing operations would have been disposed of by an administrator at the earliest opportunity subject to further assumptions about periods for marketing and sales processes where appropriate. For the tangible fixed assets (other than property) I have assumed that their disposal would have taken place during the first year of the administration. I have assumed that the heritable property would have taken longer to realise as a result of the then market conditions. I have assumed that the freehold branches/property, with the exception of the Head Office buildings, would have been disposed of during the second year of the administration at an assumed discount to their valuation in early 2009.

Corporation tax

Tax receivable has been included at the amount of actual amounts received, which I have assumed would have been ascertainable at the Relevant Date. This gives rise to a tax asset of £8 million, and a positive adjustment of an equal amount.

Impact

The cumulative impact of all of the above results is, in my calculation, that there would have been £751 million of cash receipts from such assets, a shortfall of £106 million against reported opening asset carrying values.

Appendix E: Run-off of mortgage loans

Introduction

DBS' mortgage loan portfolios at 29 March 2009 (as derived from its balance sheet at that date) are summarised in the table below.

	Book Value (29 March 2009)
Own originated mortgages	1,069
Social housing	482
Commercial loans	674
Third party acquired mortgages	191
Provisions	(36)
Total	**2,380**

The following characteristics of the portfolios at Administration Inception are relevant to my Determinations.

- The *own originated* mortgage portfolio comprised over 20,000 retail mortgages, 90% of which were in Scotland. 15% of the portfolio was represented by buy-to-let mortgages, 65% of which were on an interest – only basis.
- The *social housing* portfolio comprised predominantly long-dated loans (82% of the portfolio has a maturity of over 25 years) to smaller Scottish Housing Associations. Although creditworthiness in the sector is high, the bulk of DBS' Housing Association loans were at very low interest rates
- The *commercial loan portfolio:*
  - represented a relatively new activity for DBS, having been marketed aggressively only since 2004;
  - was highly concentrated: of its 186 loan counterparties, the largest 10 accounted for 41% of the portfolio;
  - was comprised of loans that were predominantly interest-only; and
  - was classified by DBS' internal risk analysis such that 34% of the portfolio was assessed as high risk (defined as subject to a high risk of loss) and a further 30% was on a watch list (with indicators of potential issues).

- The *third party acquired mortgage* portfolio comprised three bought-in loan books, from GMAC, SPML and Aegon, and an equity release portfolio: 80% of the non-equity release portfolio related to buy-to-let or self-certified mortgages, which, on the basis of general information which I have considered, lead me to assume that such mortgages would have been subject to higher delinquency rates than own - originated loans.

Realisation strategy

As noted in Section 2.4.2 of this Report, I have assumed that DBS' loan portfolios would have been subject to a longer term run-off strategy. The anticipated loss in value compared to their book value referred to below is a consequence of:

- impairments I assume would have arisen, which will impact on interest income and prepayment rates; and
- the discount I assume would have arisen on the sale of the residual loan portfolios at the end of the 10^{th} year of the administration in the counterfactual insolvency scenario.

The values contemplated below take no account of either the interest income on the loan portfolios nor related operating costs, both of which are addressed in Sections 4.3 and 4.4 of this Report.

Post Administration performance

Assessing the likely performance of the mortgage portfolios in the counterfactual insolvency scenario – initially in conditions of severe recession – requires the exercise of judgment. To estimate performance, I have assumed the likely quantum and timing of realisations of each component part of the mortgage portfolios separately, having regard to the following considerations.

Mortgage impairments

The likely loss on mortgage portfolio carrying value (in excess of the £36 million already provided at the Relevant Date) as the portfolio was run off would have been affected by the combined impact of:

- *probability of default*, i.e. those mortgages likely to fall into arrears, which an administrator in the counterfactual insolvency scenario would not have considered likely to be rectified, and would therefore have sought to realise by way of repossession and forced sale; and
- *loss given default*, i.e. the loss likely to have been realised on such forced sales.

These ratios would also have been affected by macro-economic factors such as interest rates, house price movements, unemployment, and GDP growth.

I have made assumptions about and calculations of the likely impact of these factors on DBS' own originated mortgage and third-party acquired books by reference to a combination of benchmarks, including relevant private company projections to which I have been given access, and analysts' forecasts for UK retail operations of publicly quoted companies in the sector,In calculating the level of impairments, I have also reviewed the underlying credit risk in relation to a substantial and risk-focused sample of individual loans in DBS' commercial portfolio, which was more concentrated than the residential mortgage portfolio, in order to assess potential losses, by reference to internal management documentation, and in discussions with the BSS Administrators.

Mortgage prepayments (attrition)

The level of mortgage prepayments would have affected cash flows in the counterfactual insolvency scenario as regards both:

- cash flow timing and interest income calculations, and
- potential impairment levels, as prepayments would reduce the value of residual mortgages at risk.

Prepayments would have been affected by similar macro-economic factors to those described above.

I have made assumptions about and calculations of likely prepayment rates for DBS' residential mortgage portfolios based on information on comparable organisations made available to me in the course of my enquiries.

Discount on sale of residual portfolios

In respect of mortgage assets which are anticipated to have been retained throughout the administration period in the counterfactual insolvency scenario – including a significant portion of the Social Housing portfolio – I have made assumptions about and calculations of potential discounts on a year ten disposal based on my own assessment of likely market conditions at that time and by reference to information obtained from another UK mortgage lender.

Timing

I have assumed that realisations of mortgage assets would have followed stated repayment schedules set out in the relevant underlying loan documentation, adjusted for prepayments and impairments, with the exception of a small number of asset portfolios (accounting for less than 5% of the net realisable value of the mortgage portfolios) which I have assumed an administrator in the counterfactual insolvency scenario would have sought to dispose of prior to the end of the ten year administration period.

Impact

The application of the assumptions derived from the above considerations leads me to calculate that significant adjustments to mortgage asset carrying values as stated in the opening balance sheet would have been necessary, both in order to recognise required additional impairments over the period of the administration in the counterfactual insolvency scenario, and the anticipated loss on sale of the remaining parts of the portfolio after ten years, at the close of the administration. I have calculated that these adjustments would have amounted to £405 million, the bulk of which would have related to impairments of assets during their run-off.

This would have resulted in £1.975 billion of cash receipts from the realisation of the portfolio (before considering any related interest income) over the period of the administration in the counterfactual insolvency scenario.

Appendix F: Adjustments to liabilities

As noted in Section 5 and Table 5.1 of this Report, the claims on the administration in the counterfactual insolvency scenario would have been likely to exceed those reported on a going concern basis at Administration Inception. An explanation of my calculation of these adjustments is set out below.

Claims arising on insolvency

The closure of DBS' operations would have given rise to a number of additional liabilities, including the following examples.

- *Employment claims* would have resulted from the immediate termination of all staff contracts in the branch network and a significant proportion of the head office staff;
- *Landlords' claims* would have arisen from the landlords of DBS's leased branches, as a consequence of an administrator's immediate closure of the branch network following Administration Inception; and
- The closure of the branch network would also have resulted in the *termination of* a number of *long term supply contracts* for items such as software licensing and support, utilities, equipment rentals and other services. Such contracts often contain termination provisions resulting in increased claims (e.g. for failure to give notice or minimum values of services in a period). I have assumed that most of these claims would have been admissible in the administration.

Based on assumptions that I have made, I have calculated that the above factors would have given rise to claims of £16 million, of which £1 million would have been represented by claims from preferential creditors.

Tax and other liabilities

Tax liabilities payable have been included at the values that I am informed have subsequently been paid, which I have assumed would be ascertainable at the Relevant Date. DBS' opening balance sheet included a tax asset of £11 million, which was classified as a negative liability. I have reversed this for the purposes of my calculations – thus crystallizing a negative adjustment – and shown the eventual amount received as a positive adjustment to opening assets (see Appendix D).

Other liabilities and accruals relate to the normal trading activities of DBS and as such have not been amended from the figures shown in the opening balance sheet.

Pensions

At 29 March 2009 DBS had a defined benefit pension scheme with an accounts-based deficit of £6 million.

On administration in the counterfactual insolvency scenario, I have assumed that the scheme would have become an unsecured creditor of DBS, with a claim equal to a “Pensions Act Section 75” debt of £38 million, which is the amount that has actually been paid. For the purposes of my calculations, I have accordingly increased the opening balance sheet pension provision of £6 million by £32 million to reflect this.

Appendix G: Glossary

Administration Inception means 30 March 2009 as described in paragraph 1.3 in Part B of this Report

Administration means administration in terms of Part II of the Insolvency Act 1986 and relevant Scottish Insolvency Rules

Administrator means a person appointed as administrator of a building society in Administration

Banking Act means the Banking Act 2009

BOE means the Bank of England

BSSA means building society special administration which has the same meaning as in the Building Societies Act 1986 (see sections 90(C)(2) and 119(1) of the Act

BSS Administrators means Richard Heis, Blair Carnegie Nimmo, Michael Pink and Richard Fleming of KPMG LLP, who were appointed as joint building society special administrators of DBS on 30 March 2009 by virtue of an order made at the Court of Session

COMP means the module of the FSA Handbook which sets out the rules governing eligibility under the Financial Services Compensation Scheme

Contribution to Costs Regulations means the Financial Services and Markets Act 2000 (Contribution to Costs of Special Revaluation Regime) Regulations 2010 (SI 2010/2220)

Counterfactual insolvency scenario has the meaning set out in paragraph 1.1 of Part B of this Report

DBS means Dunfermline Building Society

Determinations mean together the determination by the independent valuer of (1) the amounts that would have been likely to be recovered by the FSCS in respect of DBS if the stablisation power had not been exercised and DBS had been unable to satisfy claims against it; and (2) the times at which those amounts would have been likely to be recovered

Former Regulations mean the Financial Services and Markets Act 2000 (Contribution to Costs of Special Revaluation Regime) Regulations 2009 (SI 2009/807)

FSA means the Financial Services Authority

FSCS means the Financial Services Compensation Scheme

FSMA means the Financial Services and Markets Act 2000 (as amended)

HMT means HM Treasury

Nationwide means Nationwide Building Society

Relevant Date means 30 March 2009 as described in paragraph 1.3 in Part B of this Report

Report means this report including the Determinations (in Part A) and the assumptions and calculations relevant to the Determinations (in Part B) and the Appendices

Scheme manager means the scheme manager as defined by section 212(1) of the Financial Services and Markets Act 2000

Stabilisation Power means one of the stablisation powers referred to in section 1(4) of the Banking Act

Transfer Instrument means a property transfer instrument under Part 1 of the Banking Act and as described in section 33 of the Banking Act