Outstanding loans of Northern Rock shares

Background

1. All Northern Rock shares were acquired by HM Government on 22 February under the Banking (Special Provisions) Act 2008. From 25 February, they could no longer be settled within Euroclear UK and Ireland. Euroclear UK and Ireland stated that, "Any open transactions in the Shares will require both 'seller' and 'buyer' to agree bilaterally any action required in respect of their mutual contractual rights and obligations. Each party should therefore contact directly their counterparty. Under these circumstances, Euroclear UK & Ireland, as operator of the CREST system, will not introduce any exceptional processing to accommodate closure of these open transactions."

2. The Act provides for an Order to set up a compensation scheme under which an independent valuer will assess any compensation which may be payable to holders of shares transferred to HM Government. The compensation will be paid to those on the register immediately before the transfer. The Order came into force on 13th March 2008. For any outstanding securities lending transactions, borrowers will make a manufactured payment to lenders in respect of any compensation received in relation to former Northern Rock shares.

3. It seems unlikely that compensation will be paid for some time. The following stages will/might be required (i) competitive process to select valuer (ii) valuer makes assessment (ii) HMT and other interested parties can request a revised assessment (iv) HMT or other interested parties can refer the assessment to the Financial Services and Markets Tribunal.

ISLA recommendations to market participants

ISLA believes the following recommendations represent the consensus views of the major borrowers and lenders in the UK market, although individual firms are free to negotiate other arrangements bilaterally.

- Borrowers and lenders should agree between themselves the number of Northern Rock shares that were on loan at the time of the transfer to HM Government.
- The former shares might still have value depending on any compensation paid to former shareholders. Where securities loans are outstanding, their valuation is important in order to ensure that counterparty risk is minimised: a high valuation exposes the borrower to potential counterparty risk on the lender if it provides too much collateral; a low valuation exposes the lender to potential counterparty risk on the borrower if it receives too little collateral. A valuation should be agreed bilaterally by lenders and borrowers. ISLA understands that most market participants are using the value of Northern Rock shares immediately before they were transferred (90p) but some are using lower prices (eg based on the grey market) or 0p.
- By bilateral negotiation, lenders and borrowers may agree to ‘cash out’ positions (ie the lender agrees to terminate the loan in return for a cash payment) based on an agreed price for the former Northern Rock shares.
- If positions are left outstanding, the fee on such ‘loans’ should be set to zero from a date agreed between the parties on the basis that the former shares have ceased to have value to the borrower.

International Securities Lending Association
30 March 2008