Dunfermline Building Society
(in building society special administration)

Joint administrators' progress report to creditors pursuant to Rules 26 to 29 of The Building Society Special Administration (Scotland) Rules 2009

6 months to
29 September 2009

KPMG LLP

28 October 2009

This report contains 20 Pages

Contents

Appendices

Notice: About this Report

This Report has been prepared by the Joint Building Society Special Administrators of Dunfermline Building Society ("DBS"), solely to comply with their statutory duty under the Rules (26 to 29) of The Building Society Special Administration (Scotland) Rules 2009, to provide the creditors with an update on the progress of the Administration, and for no other purpose. It is not suitable to be relied upon by any other person, or for any other purpose, or in any other context.

This Report has not been prepared in contemplation of it being used, and is not suitable to be used, to inform any investment decision in relation to the debt of or any financial interest in DBS.

Any estimates of outcomes for creditors included in this report are illustrative only and cannot be relied upon as guidance as to the actual outcomes for creditors. Any person choosing to rely on this report for any purpose or in any context other than under Rules 26 to 29 does so at their own risk.

To the fullest extent permitted by law, the Joint Building Society Special Administrators (the "Joint Administrators") do not assume any responsibility and will not accept any liability in respect of this report. Blair Nimmo is authorised to act as an insolvency practitioner by the Institute of Chartered Accountants of Scotland; Richard Heis and Mike Pink by the Institute of Chartered Accountants in England & Wales and Richard Fleming by the Insolvency Practitioners Association. The Joint Administrators act as agents for DBS and contract without personal liability. The appointments of the Joint Administrators are personal to them and, to the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability to any person in respect of this Report or the conduct of the Administration.

1 Glossary

Banking Act 2009	The Act.
BoE	Bank of England.
Bridge Bank	DBS Bridge Bank Limited - a wholly-owned subsidiary of the BoE incorporated to hold and support DBS's social housing portfolio, consistent with the objectives of the special resolution regime, providing time to secure a permanent solution, such as an onward sale.
BSSAR	Building Society Special Administration (Scotland) Rules 2009.
DBS	Dunfermline Building Society (in building society special administration).
First PTI	Dunfermline Property Transfer Instrument 2009 made by the BoE exercising its powers under the Act, a copy of which can be viewed at http://tiny.cc/DBS_PTI, as amended by the Section 75 Order and the Second Section 75 Order.
HMT	Her Majesty's Treasury.
Joint Administrators	The joint building society special administrators, being Richard Heis, Mike Pink and Richard Fleming of KPMG LLP, 8 Salisbury Square, London EC4Y 8BB and Blair Nimmo of KPMG LLP, Saltire Court, Castle Terrace, Edinburgh EH1 2EG – appointed on 30 March 2009.
NBS	Nationwide Building Society.
Objective 1	Objective 1 is to ensure the supply to Nationwide Building Society and/or DBS Bridge Bank Limited of such services and facilities as are required to enable them, in the opinion of the Bank of England, to operate effectively.
Objective 2	Objective 2 is to:- a) rescue the residual building society as a going concern, or b) achieve a better result for the residual building society's creditors as a whole than would be likely if the residual building society were wound up without first being in building society special administration.

Second PTI	DBS Bridge Bank Limited Supplemental and Onward Property Transfer Instrument 2009 made by the BoE exercising its powers under the Act, a copy of which can be viewed at http://tiny.cc/DBSPTI2
Second Section 75 Order	Amendments to Law (Resolution of Dunfermline Building Society) (No.2) Order 2009
Section 75 Order	Amendments to Law (Resolution of Dunfermline Building Society) Order 2009
Pension Trustees	The Trustees of the Dunfermline Building Society 1974 Pension and Life Assurance Scheme.

2 Introduction

We, Richard Heis, Blair Nimmo, Mike Pink and Richard Fleming of KPMG, were appointed Joint Administrators of DBS on 30 March 2009, by an order made by the Court of Session in Edinburgh under an application made by the BoE under the BSSAR (which was enacted following the Banking Act 2009 that had introduced the Special Resolution Regime).

In accordance with the BSSAR we set out below our first six monthly progress report. However, in accordance with paragraph 26(5) of the BSSAR the disclosure of certain sensitive information relating to certain assets and liabilities which could seriously prejudice the commercial interests of DBS and its creditors has been either excluded from this report or abbreviated in order to preserve value for the benefit of creditors

The receipts and payments account for the period 30 March 2009 (the date of appointment) to 29 September 2009 is attached at Appendix 2. This shows funds in hand totalling £60.1m.

3 Building Society Special Administration procedure

3.1 Objectives 1 and 2 of the BSSAR

Under the BSSAR, building society special administrators have two special objectives, known as "Objective 1" and "Objective 2", which override the normal statutory objectives of administrators as set out under Scottish insolvency law.

Objective 1 is to ensure the supply to NBS (as Private Sector Purchaser of certain assets and liabilities) or Bridge Bank of such services and facilities as are required to enable them, in the opinion of the BoE, to operate effectively. During this Objective 1 stage the Joint Administrators have pursued Objective 1 principally by procuring the provision of IT services from its wholly-owned subsidiary, Dunfermline Solutions Limited, for the benefit of NBS. There remain a number of complex issues to be resolved before this stage of the process is complete.

Upon appointment, the BoE made a short term loan facility of £10m available to the Joint Administrators. However, the subsequent cash flows in the administration meant that this was never required and the facility was allowed to expire undrawn.

Objective 2 is to either: a) rescue DBS as a going concern; or b) achieve a better result for DBS's creditors as a whole than would be likely if DBS were wound up without first being in building society special administration.

Objective 1 takes priority over Objective 2, although the Joint Administrators are obliged to begin working towards both objectives immediately upon appointment.

The Joint Administrators have concluded that it is not practicable to rescue DBS as a going concern given the majority of its assets, all employees and infrastructure have been transferred to NBS or Bridge Bank. Accordingly the Joint Administrators are pursuing Objective 2(b), rather than 2(a).

The Joint Administrators immediately commenced working towards Objective 2 and in any instance of conflict between the two Objectives, have given Objective 1 priority in accordance with section 137(2) of the Act.

3.2 Property Transfer Instrument

Immediately prior to our appointment, the BoE had made the First PTI which, amongst other things, had the effect of transferring the core parts of DBS to NBS or the Bridge Bank. HMT made payment to NBS in relation to the net liabilities assumed by them under the PTI in accordance with a payment agreement. On the date of the First PTI the Section 75 Order was issued, which amended the law to enable the BoE's powers under the Act to be used effectively.

On 7 July 2009 the Second Section 75 Order was issued which amended the definition of 'commercial loan' in the First PTI.

On 30 June 2009 the BoE completed the sale, following a competitive auction, of the social housing loans (and related deposits) held by Bridge Bank and five related loans which had remained in DBS's commercial loan book. The sale and transfer were effected by way of the Second PTI.

3.3 Transitional Services Agreement

The Administrators have an obligation under section 138(3) of the Act to co-operate with any request of the BoE to enter into an agreement for DBS to provide services or facilities to a private sector purchaser. The BoE issued a notice to the Administrators dated 30 March 2009, requesting that DBS enter into the Transitional Services Agreement ("TSA"), as it was the BoE's opinion that entering into the TSA would further Objective 1, as defined in s138(1) of the Act. DBS entered into the TSA further to that request.

As NBS acquired the full infrastructure and personnel of DBS under the First PTI, the TSA has ensured that DBS has continued to have the portfolio serviced in exchange for a monthly fee based on cost.

4 Progress to date including realisation of assets

4.1 Transfer of the business, assets and liabilities

By virtue of the First PTI and the Second PTI, all property, rights and liabilities (including the DBS brand name and all property, rights and liabilities that fall within any of the descriptions specified in section 35(1) of the Act) of DBS were transferred to NBS other than excluded property, rights and liabilities as summarised below (for fuller details go to http://tiny.cc/DBS_PTI):

a) the Bridge Bank business;
b) certain medium term notes and residential mortgage-backed securities held by DBS as treasury assets;
c) all property, rights and liabilities in respect of the £50,000,000 6 per cent. Subordinated Notes due 2015 issued by DBS;
d) all property, rights and liabilities in respect of acquired mortgage loans;
e) all property, rights and liabilities in respect of commercial loans;
f) the shares held by DBS in Dunfermline Solutions Limited, Dunfermline Commercial Finance Limited and Dunfermline Development Services Limited and any rights (including membership rights) and liabilities of DBS in respect of Funds Transfer Sharing Limited;
g) certain rights and liabilities of DBS in respect of shares held by shareholding members, other than the aggregate liabilities that DBS would have owed to shareholding members if shareholding members had given notice of withdrawal effective immediately before the transfer time;
h) all liabilities of DBS in connection with any breach in relation to any breach of contract or breach of duty in connection with some or all of the NBS business occurring before the transfer time, whenever that liability may arise;
i) all rights and liabilities in respect of tax;
j) any property, rights and liabilities the transfer of which would constitute a contravention of articles 3 to 7 of the Partial Property Transfers Order; and
k) all rights, obligations and liabilities under or in respect of the DBS pension scheme.

Certain other assets and liabilities were also transferred to Bridge Bank as part of the second PTI as follows:

a) All property, rights and liabilities in respect of the housing association loans together with the related housing association.

b) All property, rights and liabilities in respect of any customer databases owned by DBS relating exclusively to the property, rights and liabilities referred to above.

4.2 Treasury assets

Following the First PTI, DBS was left with approximately £189 million (at book value) of investments in bonds, Floating Rate Notes and Residential Mortgage-backed Securities. All other treasury assets were transferred to NBS, as were all of DBS's interest rate swaps, except to the extent that the contracts were excluded from the transfer by the operation of the First PTI and The Banking Act (Restrictions on Partial Property Transfers) Order 2009. The First PTI provided that property, rights and liabilities the transfer of which would constitute a contravention of article 3 to 7 of this Order were excluded from the transfer to NBS.

Immediately following our appointment, we instructed the custodian of the treasury assets, Bank of New York, to stop any further assets sales or purchases. Shortly after, Henderson Global Investors ("Henderson") was chosen from a shortlist of brokers to assist in the ultimate marketing and sale of these assets. Given the relatively high quality of the majority of the investments and the prevailing market conditions we adopted a 'hold' strategy for the time being, only seeking to sell individual Notes on an opportunistic basis or where there is higher risk.

To date we have received principal realisations and interest of approximately £38.3m from treasury assets.

We continue to regularly monitor the remaining treasury assets in the DBS portfolio but our current strategy in this respect is to hold the assets as the returns are as good, or better, than we could achieve by investing the money elsewhere.

There were two interest rate swaps where the counterparties were creditors of DBS by virtue of FRNs. These were not transferred to NBS as this would have contravened article 3 to 7 of The Banking Act (Restrictions on Partial Property Transfers) Order 2009, and therefore were excluded under the First PTI as described above. The mark to market value of the swaps was negative £4.5 million as at 2 June 2009, and to eliminate the risk of future increased liability, with the counterparties' agreement we novated the swaps to NBS at a cost of £4.5 million.

4.3 Commercial loan portfolio

On appointment the DBS commercial loan portfolio comprised 293 loans with a value of approximately £668 million. Loans had been granted to a combination of individuals, sole traders, partnerships, LLPs, syndicates and limited companies, domiciled in both the UK (primarily Scotland) and overseas.

The loans were issued for a variety of projects as follows:

- EZ developments – funding to Enterprise Zone syndicates for commercial regeneration projects;
- Developments – funding for specified residential or commercial development projects;
- Buy to Let – funding for acquisition of residential (and some commercial properties) for letting purposes;

- Commercial – funding for acquisition of commercial properties, typically owner occupied; and

- Loans to local authorities.

The TSA with NBS provides that the dedicated team of former DBS employees and systems used to manage this portfolio continue to service the loans, with the Joint Administrators overseeing their activities.

Under the terms of the First PTI, DBS also retained certain cash deposits from a number of borrowers held as collateral against their loans (see 4.6 below). These funds were initially held on trust for DBS by NBS and, post 29 September 2009, have been transferred to DBS.

As at 29 September 2009 commercial loan book realisations total approximately £27.8 million in respect of capital repayments and interest receipts.

The conditions in the credit markets this year have depressed both the quantity and prices of reported UK loan portfolio sales – even in mortgage backed securities – such that demand is low and prices are generally significantly below intrinsic asset values on a cash flow basis. Moreover, any attempt to sell the DBS assets immediately following appointment would have been interpreted as a 'forced-sale' further increasing discounts. Therefore, the current strategy for dealing with these loans is to collect revenue, restructure and work out the loans for the foreseeable future in order to maximise realisations (net of collection costs) for the benefit of the creditors. We have been contacted by a number of parties interested in purchasing the portfolio and a number of customers offering to redeem their loans at a substantially discounted value. However, these are considered to be opportunistic in nature and have not been pursued.

4.4 Retail loan portfolio

The portfolio of retail loans retained in DBS on our appointment totalled approximately £192 million consisting of some 1,712 loans. The entire retail portfolio consists of loans to individuals secured against residential properties in the UK.

As with the commercial loan portfolio, NBS currently administer these loans for DBS through the TSA, using former DBS systems and personnel. The Joint Administrators oversee these services and perform the key strategic management and controls.

To 29 September 2009 we have realised approximately £9 million in capital and interest repayments from the retail portfolio.

4.5 Equity Release

In addition to the retail loan portfolio above, DBS has retained its interest in certain equity release transactions that it had funded through a third party mortgage originator.

In a series of transactions DBS had swapped its secured loans for a fixed annuity income stream from third party insurers/reinsurers, but retained the negative equity risk relating to the portfolio. At 30 March 2009, the asset had a net book value of approximately £69 million.

On 24 July 2009 the third party mortgage originator for the equity release product was placed into administration, with partners from Deloitte LLP acting as its administrators. This could have adversely impacted the value of the annuity income stream as without the third party mortgage administrator's loan servicing capability the cash flow to the insurer/reinsurers would be interrupted. In order to protect DBS's annuity income stream we devised and implemented contingency plans, taking control of the key data relating to DBS funded loans and instructed a new third party servicer to administer the loans.

By 29 September 2009 we had received £531,000 of annuity payments and had paid £117,000 in servicing and set-up costs following the insolvency of the third party mortgage originator.

4.6 Commercial deposits

On appointment we took control of 76 deposit accounts belonging to commercial loan customers totalling approximately £2.75 million. These balances were held by DBS as collateral against their loans allowing customers to remain within their banking covenants.

4.7 Investments in subsidiaries

We are currently in the process of seeking the striking-off of Dunfermline Development Services Limited, a dormant wholly owned subsidiary of DBS with no assets.

Another DBS wholly owned subsidiary, Dunfermline Commercial Finance Limited ("DCF"), is solvent according to its latest accounts, with net assets of £1.3m. We are in discussion with its directors regarding a solvent liquidation in order to realise the residual assets of that company and return any surplus capital to DBS.

Title to certain of the IT related assets and licences historically used by DBS (and post-appointment by NBS) lies within Dunfermline Services Limited ("DSL"), DBS's only other retained and wholly owned subsidiary. DBS is procuring the provision of these IT-related assets and licences to NBS under the TSA, in accordance with Objective 1 (see 3.1 above). As DSL has net liabilities in excess of £11 million it is not anticipated that DBS will see any realisation as its shareholder.

4.8 Dunfermline Building Society Resolution fund

Following the making of The Dunfermline Building Society Compensation Scheme, Resolution Fund and Third Party Compensation Order 2009 by HMT, the Bridge Bank will, in due course, remit, via a duly appointed liquidator, the net proceeds of its sale of the social housing assets and related liabilities, to the Dunfermline Resolution Fund, net of its own and any other relevant costs. The Resolution Fund will then be paid over to DBS in accordance with that Order.

To date we have not been notified as to the timing or quantum of any receipts from the Resolution Fund; however, we do not anticipate it being received in full or in part before 2010.

4.9 Assets remaining to be realised

As referred to above, we are currently managing the orderly wind-down of the loan and treasury portfolios. We will continue to monitor all of the portfolios with a view to opportunistic sales of assets where it can be achieved at a value which we believe will maximise the return to creditors of DBS.

Due to the limited term of the TSA with NBS, we also have to conduct a transfer of the administrative and loan management functions away from NBS within the next six months. This process is complex, and time consuming, but once complete should provide a more stable platform of operations which may also enhance the prospects of any future sale of the residual portfolios should market conditions make that option commercially attractive for the DBS estate.

The treasury assets mentioned above are currently being held as the returns on these assets are better than would be received if the funds were invested elsewhere. Depending on market conditions these assets may either be held to maturity or sold, depending on which method of disposal will result in the best outcome for creditors.

5 DBS creditors

5.1 HMT

As a result of the First PTI, DBS owes HMT two liabilities. The first liability is a liability in an amount equal to the aggregate liabilities transferred to NBS under paragraph 3 of the First PTI that DBS would have owed to any person in respect of a deposit (other than certain deposits outlined in the First PTI) and any other unsecured and unsubordinated liability (other than certain liabilities outlined in the PTI), if those liabilities had not been transferred by the First PTI. The second liability is a liability in an amount equal to the aggregate liabilities that DBS would have owed to shareholding members if:

a) shareholding members had given notice of withdrawal effective immediately before the transfer time;

b) the liabilities of DBS in respect of their share accounts had not been transferred pursuant to the PTI. We have yet to receive a formal claim from HMT and, therefore, at present the quantum and ranking of its claim is uncertain.

5.2 Pension fund

In accordance with paragraph 3(3)(l) of the First PTI, DBS has retained the liability for its defined benefit pension scheme. In accordance with Section 75 of The Pensions Act 1995, The DBS Pension Scheme will make an unsecured claim in the administration representing the shortfall of the scheme assets against the cost of insuring all liabilities measured at 30 March 2009.

5.3 Subordinated loan notes

DBS issued £50.0 million subordinated loan notes with a coupon value of 6% and redemption date of 31 March 2015. The First PTI set out that the liability under these notes remains with DBS. Interest is due annually on 31 March and the 2009 payment was cancelled by us, and a claim has been submitted by the Trustee for the loan notes of approximately £53 million inclusive of accrued interest. The Trustee for the loan notes has also submitted an initial claim for fees and expenses of £0.1m.

5.4 General

Aside from the claims referred to above, we have also identified 30 potential unsecured creditors' claims totalling £8.73 million, the largest of which is a potential claim from another financial institution for £8 million in respect of its sub-participation in some of DBS's commercial loans.

6 Other matters

6.1 Tax and VAT matters

We have completed our initial review of the corporation tax affairs of DBS which shows that corporation tax payments totalling £7.1 million were made in the three years ending 31 December 2007, and an instalment of corporation tax totalling £510,000 was made in respect of the year ended 31 December 2008. We have already received repayment of the £510,000 in respect of 2008 and are currently investigating the potential reclaim of the remaining tax paid in recent years, given the extent of the losses for the full year ending 31 December 2008 and for the period up to 30 March 2009.

We have opened dialogue with HMRC to agree the principles of our proposed tax refund claim, and have already submitted a draft corporation tax computation for the year ending 31 December 2008.

6.2 Statement of affairs

The directors submitted their Statement of Affairs to the Administrators on 15 May 2009. As a substantial proportion of the assets of DBS had yet to be realised the Administrators considered that it would not be in the best interest of creditors to disclose certain details relating to the assets and the directors' estimates of future realisations contained in the Statement of Affairs. On 11 June 2009 the Court of Session in Edinburgh approved our request to limit the disclosure of the certain parts of the directors' Statement of Affairs. The specific sections agreed to be excluded relate to assets which may be subject to market sales in due course, namely treasury assets (portfolio details, book values and estimated market values all to be excluded), and the mortgage assets (total aggregate value to be disclosed, but book value and estimated market value per portfolio to be excluded).

The redacted Statement of Affairs was filed with the FSA on 14 July 2009.

6.3 Statement of Proposals

In accordance with Section 147 of the Banking Act 2009, as we are still in the Objective 1 stage of the special administration, we issued a Statement of Proposals in accordance with the Act on 16 July 2009.

Once Objective 1 is achieved we will be in a position to issue proposals to creditors advising of how we intend to exit the special administration and make distributions to creditors.

6.4 Joint Administrators' fees

I enclose, at Appendix 3, an analysis of our time and costs properly incurred up to 29 September 2009. In this period, a total of 16,855 hours were spent by me and my firm's staff in relation to the activities listed below at a total cost of £6,102,258. In accordance with the BSSAR, these costs and our hourly rates have been approved by the BoE. To date we have drawn £5,315,966 in fees and £121,883 in expenses.

R Heis
Joint Building Society Special Administrator

28 October 2009

Appendix 1

Statutory and other information

Statutory and other information

Relevant court
The Building Society Special Administration Order was made in the Court of Session in Edinburgh on 30 March 2009.

Registered office and trading address

The former registered office of Dunfermline Building Society was situated at:

Caledonia House
Carnegie Avenue
Dunfermline
Fife KY11 8PJ

As part of the Administration process, the registered office for the Company has been changed to:-

191 West George Street
Glasgow
G2 2LJ

Joint Administrators and their functions

Richard Heis, Mike Pink and Richard Fleming of 8 Salisbury Square, London EC4Y 8BB and Blair Nimmo of Saltire Court, Castle Terrace, Edinburgh EH1 2EG were appointed as Joint Administrators of DBS on 30 March 2009. All of the Joint Administrators act jointly and severally in the pursuance of Objective 1 and Objective 2 of the Building Society Special Administration of DBS.

Appendix 2

Administrators' receipts and payments accounts to 29 September 2009

	Total
Receipts	**£'000**
Treasury assets	38,287
Commercial portfolio realisations	27,769
Retail portfolio realisations	9,006
Equity release funds received	641
Bank interest	18
Tax refund	510
Commercial Deposits (held on behalf of depositors)	374
Amounts withheld by NBS	(71)
Total receipts	**76,534**
Payments	
Drawdown payments (Commercial)	(3,701)
Drawdown payments (equity release)	(742)
Swap closure costs	(4,506)
Servicing costs	(660)
Agents fees to be charged to customers	(137)
Administrators' fees and disbursements	(4,600)
Legal costs	(699)
Agents fees and other administrative costs	(153)
Irrecoverable VAT	(828)
Force majeure payments to unsecured creditors	(282)
Total payments	**(16,308)**
Net funds in hand	**60,226**
Less: Monies due to depositors	(374)
	59,852

Appendix 3

Joint Administrators' time costs to 29 September 2009.

Statement of Insolvency Practice 9: summary of Administrators' time costs for the period to 29 September 2009

	Breakdown of hours charged by grade					
	Partner/ Director	**Manager**	**Administrator/Support**	**Total hours**	**Time cost**	**Average hourly rate**
Accounting & Administration	365.3	766.0	671.9	1,803.2	£667,540.50	£370.21
Bank & Statutory Reporting	202.7	366.5	451.4	1,020.6	£384,638.50	£376.90
Business separation and migration	97.4	2,151.7	1,364.3	3,613.3	£1,358,558.20	£375.99
Commercial portfolio	27.3	1,665.0	2,431.3	4,123.6	£1,347,979.50	£326.90
Creditors and claims	63.4	48.1	117.8	229.3	£80,506.00	£351.17
Equity Release portfolio	17.5	207.5	242.5	467.5	£163,470.00	£349.67
Investigations and CDDA	6.5	15.0	0.5	22.0	£9,170.00	£416.82
IT Security	0.6	258.4	0.0	259.0	£108,781.60	£420.07
Other asset realisation	483.4	105.0	21.7	610.1	£329,656.50	£540.33
Pension and other employee matters	141.4	67.1	169.5	378.0	£146,048.50	£386.42
Retail portfolio	27.8	586.5	1,739.3	2,353.6	£734,667.00	£312.50
Statutory and compliance	328.8	280.5	168.7	778.0	£342,459.50	£440.21
Trading	64.1	33.5	237.0	334.6	£109,104.00	£326.07
Treasury	128.0	190.5	126.8	445.3	£174,622.50	£392.15
VAT & Taxation	66.7	177.4	173.5	417.6	£145,055.50	£347.40
Total in period	**2,020.70**	**6,918.53**	**7,916.05**	**16,855.28**	**£6,102,257.80**	**£362.04**

Summary of Administrators' disbursements in the period to 7 August 2009 *

Expense type	Amount (£)
Accommodation	42,857.06
Travel	67.232.42
Subsistence	11,042.84
Communications	286.03
Other	464.33
	121,882.68

***** Latest date to which disbursements have been drawn