



HBoS Treasury Services

Covered Bond Programme

Securitisation Research

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Overview

The Covered Bond Programme launched by HBoS Treasury Services has opened up a new financing channel for UK mortgage lenders. The large issue size and low margins for these inaugural bonds illustrate the strength of appetite for such an issue and give mortgage lenders a powerful incentive to consider further similar issues.

The transaction has many similarities to one of the master trust RMBS transactions but with certain key differences. Arguably the most important difference is that the bond payments are the obligation of HBoS Treasury Services plc and are guaranteed by both HBoS plc and Bank of Scotland under the Group Guarantee. This gives rise to two important effects:

- the collateral is only needed to repay investors if the guarantors are unable to meet the scheduled bond payments; and
- the credit risk remains on the balance sheet of the originator and therefore there is no reduction in its risk capital requirement.

From an investor perspective, this gives the covered bond an advantage over the traditional RMBS structure in that provided the guarantors (HBoS plc and Bank of Scotland) remain solvent, they will be insulated against any poor performance of the underlying collateral. This is in contrast to an RMBS transaction where payment on the notes depends entirely on the performance of the mortgages. This advantage is reflected in the 20% risk-weighting for these bonds compared to 50% for traditional RMBS.

Credit support in the covered bond programme is provided by over-collateralisation rather than including subordinate tranches of bonds in the structure. The minimum balance of the mortgage pool is calculated so that only up to the first 60% of the indexed property value is taken into account, and there is at least 12% credit enhancement plus additional amounts for any obligations to fund flexible mortgage redraw amounts and the potential cost of carry if the mortgage needs to be sold before the maturity of the bonds. In addition, the sellers will be required to repurchase any loans that are more than three months in arrears.

For investors, this programme offers triple-A rated corporate bonds, which benefit from many features normally associated with securitisation transactions. This should allow the covered bonds to benefit from the level of ratings stability seen in the RMBS market.

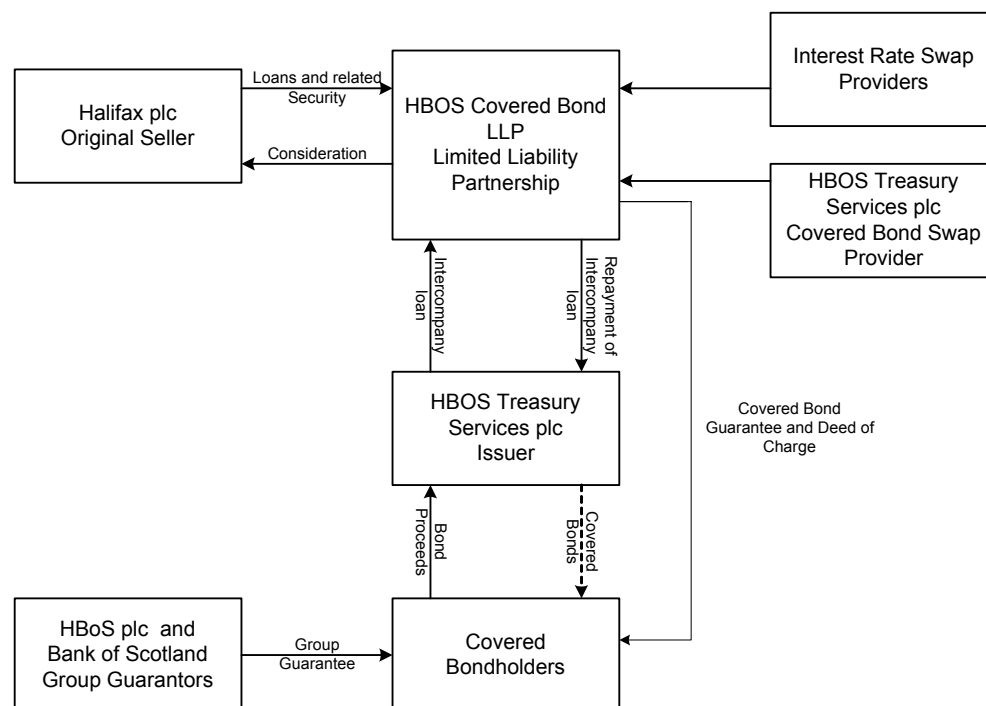
The covered bond programme provides a useful alternative source of funding for lenders that is likely to complement rather than replace RMBS issuance, but any reduction in the frequency of RMBS new issues is likely to have a positive influence on spreads.

The Bond Programme Structure

Covered Bond structure very similar to RMBS in many respects

The structure for the HBoS Covered Bond Programme is in many ways very similar to that of a master trust RMBS securitisation (see Figure 1). There is a ring-fenced pool of mortgage assets that are sold to a special purpose entity via an equitable assignment. These mortgage assets become the collateral that provide support for the bonds in the event that HBoS plc and Bank of Scotland are unable to meet the required payments on the bonds.

Figure 1: Transaction Structure



Source: HBoS Covered Bond Programme preliminary offering circular.

While the mortgages transferred to the Limited Liability Partnership (LLP) in conjunction with this first issue of covered bonds were all originated by Halifax, this programme is open to any other member of the HBoS Group. It is anticipated that each seller will service the mortgages that they sell to the LLP and also provide any interest rate swaps that might be required to hedge the basis risk between the interest rates on the mortgages and the intercompany loan agreement.

The programme has currently been set up to allow up to the equivalent of €14bn of covered bonds to be issued, although this could be increased later under the terms of the programme agreement. The current notes and any further issuance will be supported by mortgages owned by the LLP.

This issue

The first issue was of €3bn of fixed rate bullet bonds, paying 3.75% annually on 26 July to be redeemed on 26 July 2010. The Issuer (and if necessary the Group Guarantors) will be required to gross up interest payments to cover any withholding tax that may be imposed (except in certain limited circumstances) or alternatively the Issuer may call the bonds at par. The LLP will not be required to pay these additional amounts.

The redemption date for these bonds will only be brought forward if after an HBoS Event of Default, the Amortisation Test suggests that the collateral held by the LLP will not be sufficient to meet its obligations under the bonds.

Future Issues The documentation for the covered bond programme allows for full flexibility for future issuance out of this programme in terms of redemption terms, interest rate type and currency of denomination. All covered bonds in issue at any time will rank *pari passu* with each other.

Credit Structure

Payments under the covered bond programme are obligations of the Issuer, HBoS Treasury Services plc, which is a wholly owned subsidiary and fully backed by The Bank of Scotland.

Group Guarantee The covered bonds will be jointly and severally guaranteed by HBoS plc and Bank of Scotland (the Group Guarantors). These obligations will rank *pari passu* with the other unsubordinated, unsecured obligations of the guarantors.

In addition, the payments under the covered bonds are further guaranteed by the LLP following an HBoS Event of Default. The LLP will rely on the proceeds derived from the assets it holds to make these payments. If these proceeds were to be insufficient to meet obligations to bondholders in full, they will still have an unsecured claim against the Issuer and Group Guarantors for the shortfall.

Over-Collateralisation In order to reduce the risk of there ever being a shortfall, this programme includes a dynamic Asset Coverage Test that requires the balance of the mortgages in the collateral pool to significantly exceed the balance of the outstanding covered bonds.

The Asset Coverage Test is passed provided the aggregate principal outstanding of all the covered bonds is less than or equal to the sum of the following items:

- the lower of the Adjusted Current Balance of each loan or asset percentage of the Current Balance of each loan (excluding any loans in breach of the representations and warranties); plus
- any available principal receipts; plus
- cash contributions; plus
- substitution assets; plus
- any loan sale proceeds credited to the Pre-Maturity Liquidity Ledger;

MINUS the following items:

- 5% of the current balance of the loans;
- 8% of the aggregate redraw capacity multiplied by three; and
- 0.65% of the covered bonds principal balance multiplied by the weighted average maturity of the bonds.

The Adjusted Current Balance of a loan is the lower of either the actual current balance of the loan or 60% of the indexed LTV where the indexation calculation only takes into account 85% of any increase in property value (but takes full account of any decline from the original valuation).

This test is designed to ensure that the assets held by the LLP should be sufficient to cover the outstanding bonds at all times. It only takes into account the first 60% of the indexed property value for any loan and ensures that the over-collateralisation is at least 7%, plus an additional 5% to cover for potential set-off risks and variable amounts to take into account potential redraw risks and the estimated cost of carry if the LLP is required to sell the mortgage collateral before the maturity of the bonds. If this test is

failed, additional loans or cash must be transferred to the LLP before the next calculation date, one month later, or an HBoS Event of Default will occur.

Repurchase of arrears loans The Seller of any mortgages to the LLP must agree to repurchase any of those loans where the borrower falls more than three months behind with the payments. If a seller fails to repurchase any such loan, it will be excluded from the collateral used in the Asset Coverage Test, increasing further the over-collateralisation of the bonds.

Reserve Fund If the Issuer's short-term ratings are downgraded below A-1+ (S&P), P-1 (Moody's) or F1+ (Fitch), the LLP will be required to establish a Reserve Fund to retain an amount sufficient to meet the next interest payment on each series of covered bonds from available revenue receipts. This amount will be retained in the GIC account. If subsequently there is an HBoS Event of Default, the contents of the Reserve Fund will form part of Available Revenue Receipts to be used by the LLP to meet its obligations under the covered bond guarantee.

Pre-Maturity Test The Pre-Maturity Test is designed to ensure the LLP will have sufficient cash available to meet its possible obligations to make a redemption payment for a series of hard bullet covered bonds. If, in the last six months before a hard bullet payment date, the Issuer's short-term ratings fall to below A-1+ (S&P), or F1+ (Fitch) or the Issuer's long-term Moody's rating falls to A2 or below or the Moody's short-term rating falls to P-2 or below, the Pre-Maturity Test will trigger the LLP to raise the cash to meet its potential obligation by selling randomly selected loans.

The balance of loans that to be sold will be calculated as a pro rata proportion of the asset pool based on the balance of covered bonds (adjusted to account for potential cost of carry to their redemption date). This balance of loans to be sold will be reduced by the balance of the Pre-Maturity Ledger available to meet this payment and by any cash contribution received by the LLP. The seller for each loan will have the right of pre-emption (at a pre-determined price) before these are offered to any third party purchasers.

Amortisation Test The Amortisation Test is designed to ensure that the assets will be sufficient to enable the LLP to repay the covered bonds. It only applies after an HBoS Event of Default has occurred and therefore covered bond holders will be relying on the guarantee from the LLP. The test will be failed if the Amortisation Test Aggregate Loan Amount falls below the outstanding balance of all the covered bonds.

The Amortisation Test Aggregate Loan Amount is calculated as:

- the lower of:
 - ▶ current balance of the loans; or
 - ▶ 90% of the indexed valuation
- (except that the contribution of any loan which is three months or more in arrears will be reduced by 70%); plus
- any cash amounts held by the LLP; plus
- any substitution assets;

minus an adjustment for the cost of carry.

Other Safeguards The HBoS Covered Bond Programme includes a number of other safeguards. In particular, there are minimum rating requirements for the various third parties that support this transaction, including the swap counterparties and cash manager, and there are independent audits of the calculations made on a regular basis.

Allocation of Cash Flows

The cash received and held by the LLP will be separated into principal and revenue amounts and distributed according to separate priorities of payments.

Revenue Amounts

The available revenue receipts will consist primarily of interest received on the mortgages during the previous month, but will also include any releases from the Reserve Fund, interest from deposits and other investments and interest amounts received under swap agreements but excluding any amount belonging to third parties.

Provided the LLP has not received a Notice to Pay and there has been no LLP Event of Default, the Available Revenue Receipts will be used to pay amounts in the following order of priority:

- amounts due to third parties not covered elsewhere and any LLP tax liability;
- pro rata, fees due to the servicers, cash manager, account bank and corporate service provider;
- amounts due to the interest rate swap providers;
- amounts required to bring the Reserve Fund up to its required level (if applicable);
- amounts required to bring the Pre-Maturity Ledger up to its required level (if applicable);
- if a servicer event of default has occurred
 - ▶ all remaining Available Revenue Receipts will be retained in the GIC Account until either the event of default is remedied or an alternative servicer is appointed;
- otherwise
 - ▶ remaining amounts will be used to pay any swap termination amounts, amounts due to the Issuer under the intercompany loan agreement, deferred consideration to the sellers and then any remaining amounts to the members according to their respective interests in the partnership.

Summary information only – see Offering Circular for full details.

Principal Amounts

Available Principal Amounts consist primarily of principal receipts on the mortgages during the previous month plus any other unused principal amounts or cash contributions and any releases from the Pre-Maturity Ledger following the redemption of any hard bullet covered bonds.

Before acceleration of the bonds Available Principal Receipts will be used in the following order of priority:

- if the Pre-Maturity test has been failed to credit the Pre-Maturity Ledger up to its required amount;
- to acquire sufficient new loans (if available) to ensure the Asset Coverage Test is passed;
- to deposit a sufficient amount in the GIC Account to ensure compliance with the Asset Coverage Test;
- if all amounts outstanding under a series of bonds have been repaid in full, repayment of the corresponding term advance of the intercompany loan;
- subject to compliance with the Asset Coverage Test, returning remaining principal receipts to the relevant seller.

Summary information – see Offering Circular for full details

- Trigger Events** There are a number of trigger events in the covered bond structure, the first being an HBOs Event of Default. This can occur in a number of situations including the following:
- failure to pay any interest or principal amount when due by the Issuer and the Group Guarantors;
 - bankruptcy or legal proceedings being taken against any of these parties,
 - failure to rectify any breach of the Asset Coverage Test; or
 - failure to rectify any breach of the Pre-Maturity Test.

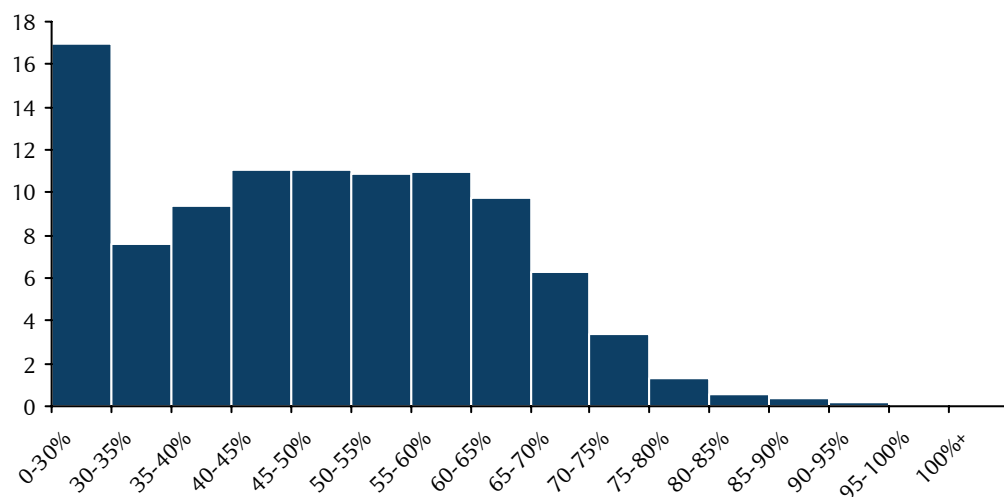
An HBOs Event of Default will not accelerate payments to covered bondholders but will allow the security trustee to start proceeding against the Issuer and Group Guarantors while the asset pool is wound up in an orderly fashion.

The second event of default is the LLP Event of Default. This would arise after an HBOs Event of Default if the LLP failed to make any payments when due, legal proceedings were started against it or the failure of the Amortisation Test. This will cause the acceleration of payments to covered bondholders and their redemption at the early redemption amount relevant to that particular covered bond.

Analysis of Over-collateralisation

There is no detailed information on the mortgages contained in the collateral pool supporting this bond programme. There are a limited number of eligibility criteria but even these are subject to revision over time and there is likely to be continuous purchase of new collateral, which may include new products. However, in order to illustrate the over-collateralisation mechanism, it is possible to use the indexed LTV distribution of the Permanent Financing master trust shown in Figure 2.

Figure 2: Indexed LTV Distribution of Permanent Financing Collateral Pool (% by balance)



Source: Permanent Financing Investor Report, June 2003.

Assuming there is no flexible redraw capacity in the asset pool and that its indexed LTV distribution is similar to that of the Permanent Financing master trust, we calculate that the current total over-collateralisation requirement would be of the order of 19%. Admittedly there may be some bold assumptions included in here but it does illustrate the considerable credit enhancement supporting the HBOs Covered Bonds.

Impact on UK RMBS Market

A key question for investors in RMBS transactions is whether this new form of mortgage based financing will change the dynamics of the RMBS markets. This will depend to a large part on whether other RMBS issuers follow suit.

A covered bond programme appears to have a number of advantages for RMBS issuers, including:

- ability to target a different investor base – therefore reducing reliance on a single programme;
- greater flexibility to include new mortgage products; and
- cheaper longer-dated funding.

There are obligations imposed on the issuers, including the requirement to repurchase delinquent loans, and they may have to allow the LLP to sell mortgages in certain circumstances. It is also a structure that requires significant over-collateralisation.

From an investor's perspective, the covered bond programme has many of the structural safeguards associated with a securitisation transaction together with a company guarantee. The structural features should ensure that the triple-A ratings of the bonds should be well protected against likely changes in the ratings of the borrowing bank.

HBoS has already announced plans to issue as much as €4bn of covered bonds this year and other large mortgage lenders are reported to be watching the situation. We expect RMBS issuance to continue although the pace may slow and we do not expect covered bonds to replace RMBS issuance. However, a potential reduction in the rate of supply and the existence of a cheaper source of funding for mortgage lenders should encourage RMBS spreads to tighten.

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