Barclays Capital **Research**

Barclays Capital has been mandated as lead manager for an offering by this issuer

Northern Rock – Structured Covered Bond

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Figure 1: Ratings

	Moody's	S&P	Fitch
Senior Unsecured	A1	A	A+
Outlook	Stable	Stable	Stable
Covered bonds (expected)	Aaa	AAA	AAA

Source: Rating agencies.

- Northern Rock is launching a global covered bond programme of €10bn, which will be used to refinance residential mortgages granted in England and Scotland and possibly at a later stage, also mortgages granted in Northern Ireland.
- The covered bonds will be direct, unsecured and unconditional obligations of Northern Rock plc and will rank *pari passu* among themselves and equally with all other present and future unsecured and unsubordinated obligations of the bank.
- In addition, Northern Rock Covered Bond LLP (LLP) – a limited liability partnership incorporated in England and Wales, legally independent from Northern Rock but consolidated in its accounts - will guarantee the payment of interest and principal on the covered bonds if Northern Rock defaults. The guarantee is irrevocable, direct and unconditional and is secured on the residential mortgages held by the LLP.
- To ensure that the adjusted aggregate amount of mortgages outstanding equals or exceeds the aggregate of covered bonds outstanding, the structure includes an Asset Coverage Test, which will be calculated by Northern Rock as Cash Manager and independently verified periodically by an asset monitor. Breach of this test will constitute an event of default for the Northern Rock and will prompt acceleration of the bonds against the Issuer, but, for the avoidance of doubt, not early prepayment of the covered bonds because the LLP will make payments on the covered bonds when due.
- As outlined in the previous paragraph, Northern Rock's default does not prompt acceleration of the bonds, unless the Amortisation Test is breached. Upon the occurrence of a Northern Rock's default, the LLP will credit all the cash received from ordinary payments/repayments as well as possible asset disposals to a GIC account then held with Lloyds TSB which will be used by the Bond Trustee (The Bank of New York) to pay guaranteed amounts on the bonds according to their original schedule.
- Covered bonds can only be issued up to a maximum of 75% of the indexed value of the properties in the asset cover pool. The remainder will be financed through a capital contribution from Northern Rock to the LLP. As a result, this structure will result in a minimum level of over-collateralisation of 133%, which should address concerns for lack of limitations over the type of mortgages that can be refinanced.

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- In addition, the market value of the assets in the cover pool has to exceed the GBP equivalent of covered bonds outstanding by at least [10%].
- Risk-weighting for these bonds will be 20%.

Key Features of Northern Rock

Profile

It has almost 5% of the UK mortgage market

Previously established as a building society, Northern Rock plc is a specialised lender which focuses on the provision of residential mortgages, personal credit and commercial lending in the UK, where it has a growing share of the mortgage market of approximately 4.8% measured by balances outstanding, and 8.1% by volume of net new mortgage loans granted during the year 2003.

Revenue diversity and cost efficiency offsets ongoing margin pressure

Northern Rock converted from a building society into a public liability company in 1997 but has not taken advantage of the wider range of services it can provide and businesses it can enter into as a plc. Instead, it continues to focus on its key markets of housing finance and personal savings, placing the emphasis on cost control and the efficient delivery of services as a way to offset ongoing lending margin pressure and preserve bottom-line results. Going forward, management has clearly indicated that it intends to carry on the current strategy of: "combining competitive pricing, effective distribution and efficient customer service" to continue to generate solid returns. In line with this strategy, management has highlighted the following financial targets for 2004: grow assets under management by 20% (-/+5%), increase pre-tax profits by 15% (-/+5%) and generate a ROE in the 19% to 22% range. Management is also confident that the growth in revenues will continue to outpace that of costs, leading to further improvements in measures of efficiency, which are already very good.

Market cap of £3.2bn as at 23 March 2004

Its share capital is widely held, although the 2003 annual report indicates that as at 24 February 2004 Barclays plc owned 4.02% of the bank's share capital. Other substantial shareholders were L&G Investment Management ltd (3.01% of the ordinary stock), Prudential plc (3.96%) and Fidelity International ltd (5.00%). As at 23 March 2004, its market capitalisation was £3.2bn.

The Northern Rock Foundation receives 5% of Northern Rock's pre-tax profits annually

Upon conversion into a plc, the company established the Northern Rock Foundation as an independent grant-making trust providing support to charitable causes mainly, but not exclusively in the North of England. At the time of its establishment, the foundation received a special class of non-voting and non-dividend paying shares which, under certain circumstances such as change in control of Northern Rock, would convert in to approximately 15% of the bank's ordinary share capital. In addition, Northern Rock has agreed to donate 5% of its pre-tax earnings to the Foundation annually, and has done so since its establishment.

Asset Composition and Quality

Loan leverage down due to the various securitisations done

At year-end 2003, the group reported consolidated assets of £37.2bn. Interestingly, despite the rapid growth in residential mortgage loans granted, levels of liquidity have increased over time, reflecting the various securitisations done (£15.7bn at 31 December 2003). As a result, gross loans of £28.2bn at year-end 2003 represented 75.9% of group assets, compared to 80.2% in 1999. Conversely, securities holdings, interbank assets and cash have increased in importance to represent 21.7% of consolidated assets in 2003, compared to 17.1% in 1999.

Figure 2: Evolution of Main Asset Items

Northern Rock Group (in £mn and %)	2003	2002	2001	2000	1999
Total assets	37,160	32,665	26,409	22,554	20,125
Risk Assets	19,691	17,248	14,858	11,986	10,135
Loans (gross)	28,202	25,035	21,006	18,138	16,134
of which residential mortgage lending	23,180	21,297	17,855	16,186	15,215
of which commercial property lending	940	743	1,059	814	549
of which unsecured loans	3,237	2,893	2,050	1,019	317
Liquid assets	8,058	6,800	4,796	3,858	3,565
Loans/assets	75.9%	76.64%	79.54%	80.42%	80.17%
Residential mortgages/net loans	82.20%	85.35%	85.25%	89.47%	94.56%
Commercial mortgages/net loans	3.33%	2.98%	5.06%	4.50%	3.41%
Unsecured loans/net loans	11.48%	11.59%	9.79%	5.63%	1.97%
Liquid assets/assets	21.68%	20.82%	18.16%	17.11%	17.71%

Source: Company Accounts, Northern Rock & Barclays Capital.

Residential mortgages account for close to 85% of loans outstanding in 2003

In line with its history and strategic emphasis on housing finance, residential mortgages represent the largest asset class in the credit portfolio, accounting for more than 80% of net loans outstanding in each of the past several years. The growing popularity of the "together" mortgage product – which combines a secured loan of up to 95% of the property value with an unsecured loan of up to 30% of the value of the property subject to a maximum of £30,000 being financed – however, has contributed to the rising importance of unsecured lending which, at year-end 2003, represented 11.5% of loans outstanding. By contrast, commercial property lending deliberately represents a very modest proportion of loans outstanding (£940mn or 3.3% of loans in 2003).

Asset quality appears sound

Asset quality is sound, partially helped by the rapid growth in loan balances coupled with the strength of the economy and the buoyancy of the housing market (52% of mortgages granted during 2003 had been granted in the South, with the residual balance equally split between the Midlands and the North of England & Scotland). The low level of first-time buyers, however, also helped preserve asset quality, with the percentage of customers with proven repayment track records increasing to 77% of the total in 2003 from 75% 12 months earlier and 68% in 2001. To help preserve sound measures of asset quality, management has also limited the size of the mortgages granted in order to focus on more marketable properties. As a result, the preponderance of the loans granted in 2003 involved amounts of less than £500,000 (loans involving more than £500,000 represented only about 4% of new loans in the year) while the percentage of mortgages with loan-to-value ratios of less than 90% increased from 61% of all disbursements in 2002 to 71% in 2003. Coupled with the rising value of the properties financed, the reduction in the average LTV granted caused the average indexed LTV to remain low in 2003 at about 55%.

NPLs remain low, even by domestic standards

At year-end 2003, residential mortgages that had been in arrears for more than three months accounted for 0.45% of the total mortgage book, down from an already low 0.56% in 2002 and 0.61% in 2001. The commercial property portfolio has also shown a low default propensity, with only 0.53% of the commercial loan balances three or more months in arrears (0.70% in 2001). The only portion of the loan book that displays higher arrears levels is the personal unsecured portfolio of £3.2bn or 11.5% of the total, where loans three months or more in arrears represented 0.98% of unsecured personal loans in 2003. Even at these levels, however, asset quality is better than the average displayed by the industry and shows a declining trend over time (three months or more in arrears represented 1.4% of unsecured loan balances in 2001).

Figure 3: Evolution of Arrears Balances

Northern Rock Group (in £mn and %)	2003	2002	2001	2000	1999
Loans (gross)	28,303	25,035	21,006	18,138	16,134
of which residential mortgage lending	23,832	21,297	17,855	16,186	15,215
of which commercial property lending	940	743	1,059	814	549
of which unsecured loans	3,237	2,893	2,050	1,019	317
>90 days arrears/residential mortgages	0.45%	0.56%	0.61%	0.65%	0.83%
>90 days arrears/commercial mortgages	0.53%	0.60%	0.70%	0.60%	N.A.
>90 days arrears/unsecured loans	0.98%	1.30%	1.40%	1.40%	N.A.

Source: Company Accounts.

Performance

Measures of performance are sound and stable

While the revenue mix of the group has changed considerably over the past few years with net interest income dropping to 45% of total revenues in 2003 from more than 71% in 1999, Northern Rock's performance has been remarkably stable, driven by a very good control of operating costs and sound measures of asset quality, which have translated into manageable loan loss provisioning needs.

Net interest income of 0.84% of average assets in 2003 is low

Lending margins have continued to narrow over the past few years, mirroring market pressures, but also the significant percentage of remortgaging activity taking place (refinancing accounted for about 40% of lending during the year), which partially reflects a deliberate policy of offering existing clients the same product range as new customers. The significant proportion of fixed rate mortgages granted (56% of the total in 2003, compared to 55% the previous year) – where margins are somewhat thinner but fees are higher than on variable rate mortgages – also help explain the tight lending margins with which Northern Rock operates as does the tough competitive environment for customer deposits.

Non-interest income has grown to 55% of revenues

Importantly, the group has managed to complement narrowing lending margins with mortgage servicing and administration fees, swap fees and other residual income arising from the securitised assets as well as fees and commissions from traditional banking services and dividends from equity investments. In total, non-interest income has grown to represent approximately 55% of group revenues in 2003 and has helped preserve total revenues at around 1.9% of average assets in each of the past several years.

The cost-to-income ratio is low at 33.2%

With approximately 85% of new business generated by intermediaries and almost 7% through the telephone and, to a lesser degree, the Internet, Northern Rock has managed to limit the size of its network of retail branches and sales centres to 64, which, in turn, has had positive repercussions on its overhead cost base. Coupled with stable revenues, tight control of operating expenses have led to a steady improvement in measures of efficiency, with the cost-to-income ratio dropping to a low 33.2% in 2003 from an already below market level of 35.3% in 1999.

Provisions for loan losses =11% of recurring profits

As indicated above, the group's sound measures of asset quality have resulted in loan loss provisioning needs that are quite modest by international standards and, at just over 11% of recurring profits in each of the past few years, manageable for a group with the recurring profitability of Northern Rock.

Recurring ROA of 0.8% is solid

As a result of the above, the group has reported sound operating and bottom line results in each of the past several years. In 2003 in particular, operating income totalled £387mn equivalent to a solid 1.1% of average assets, while net income of £275mn accounted for a healthy 0.8% of average assets. Considering the large involvement in relatively low-risk residential mortgages, the risk-weighted balance sheet is

approximately half the size of the consolidated balance sheet total. Hence, measures of profitability double if ratios are calculated against risk-weighted rather than total assets.

Figure 4: Evolution of Profitability and Performance Indicators

Northern Rock Group (in £mn and %)	2003	2002	2001	2000	1999
Total assets	37,160	32,665	26,409	22,554	20,125
Net interest income	293	300	306	279	267
Total revenues	652	561	476	414	422
Overhead costs	-216	-187	-164	-143	-131
Loan loss provisions (LLP)	-49	-43	-35	-17	-12
Operating income	387	331	278	254	278
Net income	275	230	193	182	144
Net interest income/avg assets	0.84%	1.01%	1.25%	1.31%	1.39%
Non interest income/avg assets	1.03%	0.88%	0.70%	0.63%	0.80%
Total revenues/avg assets	1.87%	1.90%	1.95%	1.94%	2.20%
Op.Inc.before LLP/avg assets	1.25%	1.27%	1.28%	1.27%	1.51%
Operating income/avg assets	1.11%	1.12%	1.14%	1.19%	1.45%
ROAA	0.79%	0.78%	0.79%	0.85%	0.75%
Return on avg shareholders' funds	21.14%	20.21%	19.49%	20.23%	16.30%
Total revenues/avg risk assets	3.53%	3.49%	3.55%	3.75%	4.16%
Operating income/avg risk assets	2.10%	2.06%	2.07%	2.30%	2.75%
ROARA	1.49%	1.43%	1.44%	1.65%	1.42%
Cost/avg assets	0.62%	0.63%	0.67%	0.67%	0.68%
Cost/income	33.17%	33.30%	34.40%	34.54%	31.15%
Net interest income/tot revenues	44.91%	53.40%	64.21%	67.34%	63.39%
Non interest income/tot revenues	55.09%	46.60%	35.79%	32.66%	36.61%
Shareholders' Funds/assets	3.73%	3.70%	4.03%	4.06%	4.39%
Tier 1 Ratio	9.30%	9.40%	8.40%	9.10%	8.70%
Total Capital Ratio	14.30%	15.50%	13.20%	13.90%	13.80%

Source: Company Accounts & Barclays Capital.

Credit Opinion

Stable credit…

The credit profile of Northern Rock is underpinned by its growing position in the UK housing market as well as solid and recurring profitability. Over the past several years, the growth in the housing market has provided a solid base to expand operations in a profitable manner and with minimal loan loss provisioning needs. The rapid expansion of the credit book, however, has caused some strains, most notably on the funding and solvency position of the group.

…which relies more on wholesale funding

With the rate of new mortgage origination outpacing that of customer deposits, management has been forced to increase its reliance on wholesale funding. The various securitisations done so far (£15.7bn) and the €10bn structured covered bond programme announced are part of the group's strategy of offsetting reliance on retail customer deposits by expanding the investor base and diversifying markets and maturities.

Securitisation positive for solvency

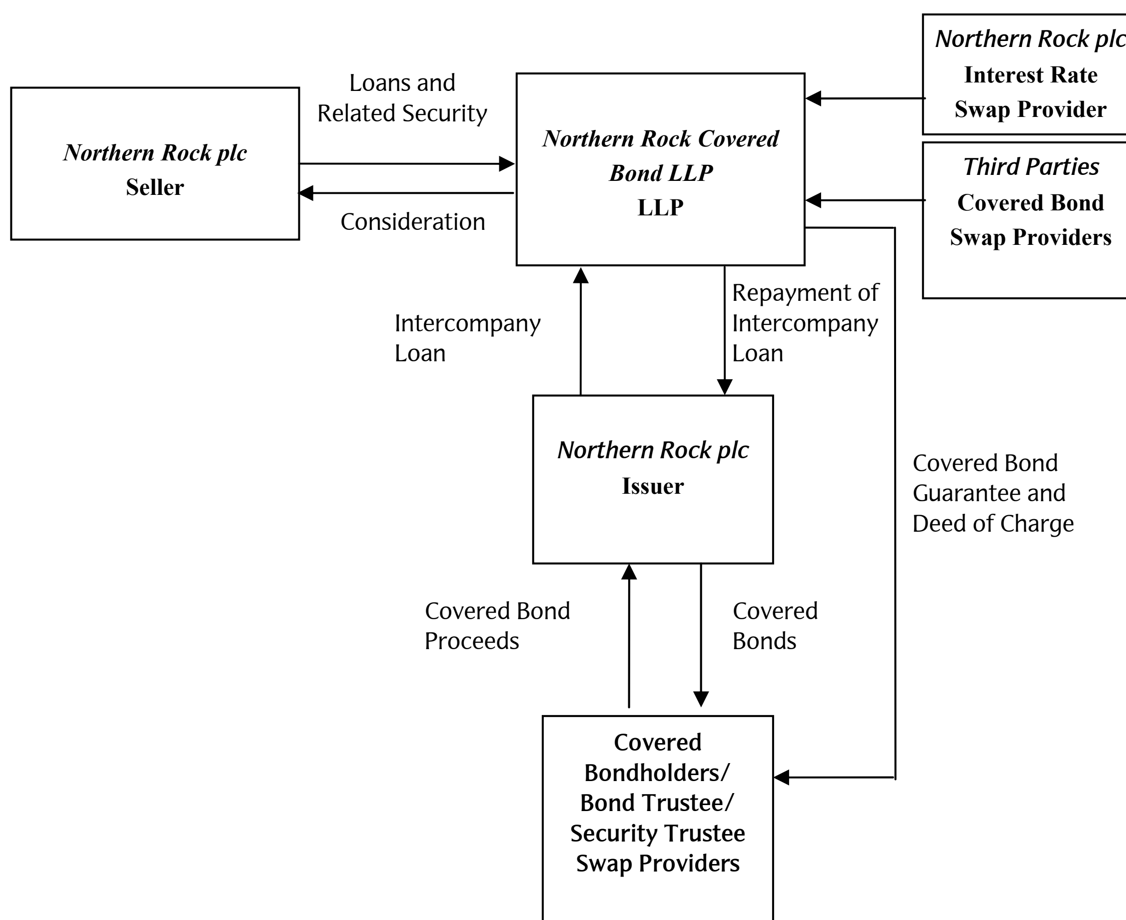
By contrast, the negative pressure on solvency stemming from the rapid growth of the balance sheet has been reduced through the non-recourse sale of residential

mortgages. At year-end 2003, Northern Rock reported a tier 1 capital ratio of 9.3%, virtually unchanged on 2002 (9.4%) and a total capital ratio of 14.3% (15.5% 12 months earlier). Even if adjustments are made to take into account the way S&P looks at Reserve Capital Instruments and Tier One Notes (which it considered as weaker quality capital instruments), the group's solvency position remains adequate with an Adjusted Common Equity to risk assets of 6.65% in 2003, compared to 6.58% in 2002 and 8.68% in 1999.

On balance, the credit profile of the group is pretty solid and unlikely to change quickly and, hence, senior debt ratings are likely to stay at current levels with stable outlooks. A severe correction in the domestic housing market, which Barclays Capital does not anticipate, could however have serious implications for the senior debt rating of Northern Rock, as it would cause a surge in arrears, while hindering new lending opportunities. By the same token, should the company be subject to a takeover, its creditworthiness could be affected by the strengths/weaknesses of the new owner.

Key Features of Northern Rock's Structured Covered Bonds

Figure 5: Structure of the Transaction



Source: Preliminary Offering Circular

The structure illustrated in Figure 5 above has been designed to produce the same benefits normally available to covered bond investors, in spite of lack of dedicated legislation to support these instruments in the UK. More specifically, with this structure, covered bond investors will have direct recourse to Northern Rock as the issuer of the bonds, but are also protected by a pool of mortgages that has been segregated and would be managed exclusively for their benefit in case of problems. More in detail:

- Northern Rock plc will issue covered bonds as its own direct, unsecured and unconditional obligations. These obligations will rank *pari passu* among themselves and equally with all other present and future unsecured and unsubordinated obligations of Northern Rock.
- The proceeds raised through the issue of covered bonds will be on-lent through an intercompany loan to Northern Rock Covered Bond LLP (LLP) – a limited liability partnership incorporated in England and Wales, legally independent from Northern Rock but consolidated in its accounts. In turn, the LLP will use these proceeds to purchase from Northern Rock portfolios of residential

mortgages or substitution assets up to 10% of the eligible asset pool. Other uses of the intercompany loan include, subject to compliance with the Asset Coverage Test (more on this later), making a capital distribution, repaying part of the intercompany loan or making a deposit into a GIC account (more on these points later).

- Assets eligible for inclusion in the asset cover pool are:
  - Residential mortgages granted in England and Scotland and, at a later stage, also mortgages granted in Northern Ireland.
  - Substitution assets, which include gilt-edged securities, demand and time deposits plus government securities or RMBS rated Aaa/AAA/AAA and with residual maturity of less than 12 months. All these assets have to be denominated in GBP.
- LLP will provide a guarantee to covered bond holders for the payment of interest and principal, which becomes enforceable if Northern Rock defaults, the bank is served an Issuer Acceleration Notice by the Bond Trustee (The Bank of New York) and LLP is served with a Notice to Pay. The guarantee represents an irrevocable, direct and unconditional obligation of the LLP and is secured on the assets of the guarantor. To ensure that these assets are used solely for the benefit of covered bonds holders, The Bank of New York has been appointed as Security Trustee and has been granted security over the assets of the LLP.
- To ensure that the adjusted aggregate amount of mortgages outstanding equals or exceeds the aggregate of covered bonds outstanding, an independent asset manager will be appointed to periodically verify an Asset Coverage Test, which has to be calculated by Northern Rock both before and after an issue of covered bonds, as well as an Amortisation Test (more on these topics later). A breach of the Asset Coverage is an event of default for Northern Rock, but does not trigger acceleration of the bonds. By contrast breach of the Amortisation test will constitute events of default for the LLP and prompt early repayment of the bonds.
- Northern Rock plc will act as the servicer under this structure as well as the interest rate swap provider, acting as counterpart for LLP which aims to match the interest received from the mortgages in the asset cover and those payable on intercompany loans. Northern Rock will also provide cash management services to the LLP and monitor compliance with the Asset Coverage and Amortisation Tests.
- Citibank will act as Issuing and Principal Paying Agent, while Lloyds TSB has been appointed as the stand-by GIC provider, ready to take over from Northern Rock if the bank's short-term rating is downgraded from P1/A1/F1.

Northern Rock's default does not trigger acceleration…

In the event of default of Northern Rock, the Bond Trustee will serve a Notice to Pay to the LLP, which, subject to the terms of the Amortisation Test, will then use all the proceeds generated by the asset pool (including possible asset sale proceeds) to pay guaranteed amounts on the bonds according to their original schedule. To ensure that all the cash paid by borrowers is used solely for the benefit of covered bond investors, these proceeds (referred to as excess proceeds) are collected into a Guaranteed Investment Contract (GIC) account with Lloyds TSB.

…but LLP's does

It is only when the LLP defaults on its obligations or the Amortisation Test fails that it is served with an Acceleration Notice and covered bonds are accelerated. In this event, the Security Trustee would step in, enforce the security created under the Deed of Charge

and use the proceeds generated by the sale of the asset cover to pay covered bond investors. Should the proceeds from asset disposals be insufficient to repay all secured claims, covered bond investors would also have unsecured recourse against Northern Rock, jointly with all other senior unsecured creditors.

Asset Coverage Test

The Asset Coverage Test is designed to ensure that at each calculation date, the adjusted aggregate mortgage loan amount in the cover pool is at least equal to the GBP equivalent of covered bonds in circulation. The test also requires that Northern Rock sells enough mortgages to the LLP or provides it with a cash capital contribution if the Asset Coverage Test is breached.

The calculation of the adjusted aggregate mortgage loan amount is based on a formula that takes into account a number of risks, including those of set-off, redraw under flexible mortgage loans, failure by Northern Rock to replace defaulted mortgages, potential negative carry as well as any excess cash available and not yet used to buy more mortgages. The formula is designed to ensure that covered bond issuance does not exceed 75% of the indexed valuation of the properties in the asset cover pool and that the minimum over-collateralisation ratio is at least 10%. The complete formula is:

A + B +C + D – (V + W + X + Y + Z), where:

- A is the lowest of the aggregate current balance of mortgages in the asset cover pool or 75% of the indexed valuation of those mortgages;
- B is any principal repayment which has net yet been used to buy new mortgages;
- C is any capital contribution or advance provided by Northern Rock that has not yet been used to buy new mortgages;
- D is the balance of any substitution assets;
- V is a factor introduced to mitigate set-off risk in respect of the together and connections mortgage accounts;
- W is a factor introduced to mitigate set-off risk in respect of other mortgage accounts;
- X is 8% of the flexible re-draw capacity * 3,
- Y is a factor designed to capture the maximum amount that borrowers can re-draw under a flexible loan and the balance of personnel loan facility as a percentage of the aggregate principal balance of all flexible mortgage loans in the asset pool; and
- Z is the balance of covered bonds outstanding multiplied by their weighted average maturity and a factor of 0.5%.

Amortisation Test

The Amortisation Test has been introduced to ensure that if Northern Rock defaults and the LLP is served with a Notice to Pay, the cover asset pool has enough assets to ensure that the LLP can meet all the obligations under the covered bond guarantee. As indicated previously, a breach of the Amortisation Test would prompt an acceleration of the bonds. Under the test, which like the Asset Coverage test is formula-based, the balance of mortgages in the asset pool adjusted to take into account possible arrears, cash credited to the GIC account and substitution assets has to be equal or greater than the balance of covered bonds outstanding multiplied by their weighted average maturity and a factor of 0.5%.

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