



# Bradford & Bingley (B&B) – Structured Covered Bond

European AAA Research

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Figure 1: Ratings

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

Source: Rating agencies.

- B&B is launching a covered bond programme of €10bn, which will be used to refinance residential mortgages granted in England. The covered bonds will be direct, unsecured and unconditional obligations of B&B and will rank *pari passu* among themselves and equally with all other present and future unsecured and unsubordinated obligations of the bank.
- In addition, B&B Covered Bond LLP (LLP) – a limited liability partnership incorporated in England and Wales, legally independent from B&B but consolidated in its accounts – will guarantee the payment of interest and principal on the covered bonds if B&B 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 B&B as Cash Manager and independently verified periodically by an asset monitor. Breach of this test will constitute an event of default for B&B and will prompt acceleration of the bonds against the Issuer, but 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, B&B's default does not prompt acceleration of the bonds, unless the Amortisation Test is breached. Upon the occurrence of a B&B default, the LLP will credit all the cash received from ordinary payments/repayments as well as possible asset disposals to a GIC account, which will be used by the Bond Trustee to pay guaranteed amounts on the bonds according to their original schedule.
- In addition, the market value of the assets in the cover pool is expected to exceed the GBP equivalent of covered bonds outstanding by at least 9%. 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 B&B to the LLP. As a result, this structure will result in a certain degree of over-collateralisation.
- Risk weighting for these bonds will be 20%.

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# Key Features of B&B

## Profile

### Focus shifted away from traditional mortgages

At year-end 2003, B&B had group assets of £32.2bn and ranked as the eighth largest mortgage lender in the UK with a market share of approximately 2.8%, and a retail network of over 500 outlets. To try to lessen the impact of competition on lending margins, management has moved away from the provision of traditional mortgages, focusing instead on specialist residential mortgages. As a result, its loan portfolio includes a high proportion of non-standard buy-to-let mortgages as well as secured loans to self-employed, equity release, high LTV and sub prime mortgages.

Bradford and Bingley Building Society converted to PLC status in December 2000, when management started to shift its strategic focus away from selling in-house manufactured and own-brand mortgages towards becoming an independent financial adviser (IFA), offering third party products. From March 2001, B&B's branches were re-branded "The MarketPlace" in order to identify them better with the chosen multi-product, multi-brand approach. This strategy was further enhanced by the acquisition of John Charcol (now Charcol), then the largest UK mortgage broker.

### Strategy aimed at being the leading UK IFA

The push to be the leading IFA in the UK was further bolstered by the acquisition of Holden Meehan, a leading fee-based IFA business, in April 2003. This deal, however, also removed the bank's protection against hostile takeovers that would have run for five years post demutualisation.

## Asset Composition and Quality

The strength of the domestic economy, coupled with the low interest rate environment and low unemployment, has prompted a very rapid growth in both residential and commercial mortgages over the past several years, with on-balance sheet loans (ie, excluding the impact of the various securitisations made) rising to represent 77% of the consolidated balance sheet total in 2003, compared to less than 74% in 2000.

In addition, commercial property and housing association lending has increased at a faster pace than residential mortgages to account for 20.8% of the loan book in 2003, compared to 10.5% in 2000. At year-end 2003, buy-to-let properties accounted for a further 34% of the loan book while loans with loan-to-value (LTV) ratios in excess of 95% represented a further 5% of the total.

Competition for new business has caused the bank to relax somewhat its lending criteria in 2003, with income multiples rising to 2.2 times single income and 2.6 times joint income compared to 2.1 and 2.5 times in 2002. The average LTV financed by B&B also increased during the year to 77% of the value of the property from 73% in 2002, a feature that has caused the proportion of residential mortgages with LTV of less than 75% to drop to 69% of the total in 2003 from 83% the previous year.

While asset quality indicators have held up well to date and mortgages 90-day-plus in arrears represent a modest 0.99% of loan balances, it is important to remember that we are in a very favourable part of the economic cycle and the group is exposed to segments of the market that are potentially more at risk should the UK housing market take a turn for the worse. These concerns are further compounded by the low reserve coverage of overdue loans (29% of gross loans in 2003).

Importantly, all lending is secured and the bank has no exposure to corporate loans, equities or insurance companies.

Figure 2: Evolution of Main Balance Sheet Items (£ mn)

	2000	2001	2002	2003
<b>Balance Sheet Summary</b>				
Total Assets	24,642	23,595	25,386	32,191
Customer Loans	18,180	17,381	19,326	24,818
of which Mortgages	18,156	17,354	19,302	24,792
Customer Deposits	17,584	16,105	16,615	17,171
Debt Funding	4,928	5,342	6,445	11,444
Total Equity	1,201	1,275	1,262	1,302
<b>Asset Quality (%)</b>				
LLPs/Pre-Prov Inc	2.93	2.33	2.20	2.45
LLRs/Gross Loans	0.16	0.19	0.21	0.20
Prob Loans/Gross Loans	1.76	1.95	1.42	0.70
Coverage Ratio	8.91	9.76	14.68	28.51
<b>Capital Adequacy (%)</b>				
Tier 1 Ratio	9.20	9.70	9.60	7.60
Total Capital Ratio	13.50	13.90	14.20	13.70
Equity/Assets Ratio	4.87	5.40	4.97	4.04

Source: Company accounts, B&B and Barclays Capital.

## Performance

### Return on average assets and equity on improving trend

In 2003, the group reported a net income of £204mn, equivalent to a return on average assets of 0.71% and return on average equity of 15.9%. Both ratios have shown an improving trend over the past few years.

Performance is underpinned by a growing contribution from non-interest income sources and modest loan loss provisions, but penalised by narrowing lending margins and an operating cost base that is high, especially by UK standards, but that partially reflects the IFA strategy pursued by management.

Despite the growth of commercial and non-standard residential mortgages, where lending margins are meant to be wider than those attainable in standard residential property loans, net interest income has continued to decline since 2001, with an especially large drop in 2003; a development that partially reflects the strain that the rapid growth in assets has imposed on the funding profile of the group. This adverse development has been only partially mitigated by the rapid increase in non interest income, which has risen to represent 41% of recurring profit, driven by fees and commissions (almost 36% in 2003). As growth in this business continues, a greater proportion of the group's income is expected to be fee based, reducing the correlation of earnings to competitive and declining lending margins.

Figure 3: Evolution of Profitability and Performance Indicators (£ mn)

	2000	2001	2002	2003
<b>Income Statement Summary</b>				
Net Interest Income	426	443	441	436
Net Fees & Com's	246	261	272	264
Trading Income	0	0	0	0
Operating Income	696	714	728	738
Operating Expenses	456	452	446	469
Pre-Provision Income	239	262	282	270
Loan Loss Provisions	7	6	6	7
Pre-Tax Profit	159	234	241	263
Net Income	77	163	172	204
<b>Profitability (%)</b>				
Return on Average Assets	0.32	0.68	0.70	0.71
Return on Average Equity	6.40	13.18	13.53	15.92
NIM	1.75	1.84	1.80	1.51
Credit Costs	0.03	0.03	0.03	0.02
Cost/Income	65.61	63.29	61.28	63.48
Cost/Average Assets	1.88	1.87	1.82	1.63

Source: Company accounts and Barclays Capital.

## Credit Opinion

**While asset quality remains sound, funding profile has been weakened**

The rapid growth in balance sheet items over the recent past has been achieved to some degree to the detriment of balance sheet strength. While asset quality remains sound, the funding profile has been significantly weakened, as the increase in retail deposit balances has lagged that of loans. Figure 4 below clearly shows these developments as customer deposits financed just over 69% of customer loans in 2003, compared to almost 97% in 2000. Over the same time period, reliance on wholesale funding has almost doubled and we would expect this trend to continue.

Figure 4: Evolution of Funding Profile

Funding Profile	2000	2001	2002	2003
Customer Deposits/Loans	96.72	92.66	85.97	69.19
Wholesale Funding/Tot. Funding	23.53	26.40	29.45	43.38

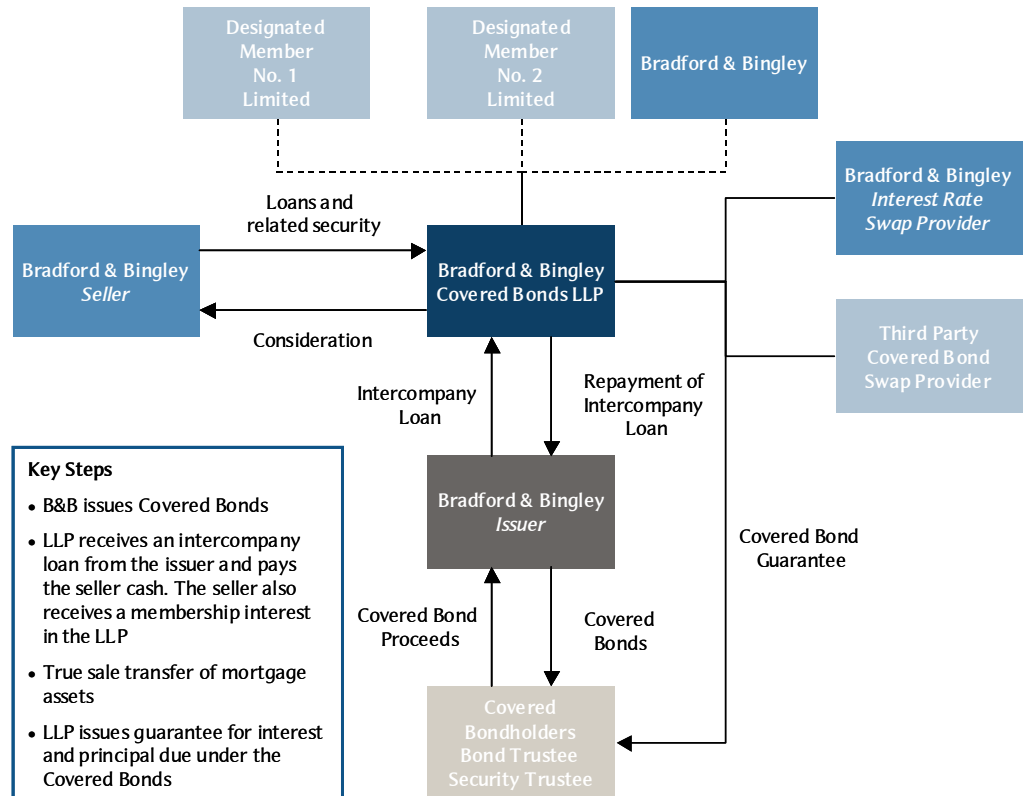
Source: Company accounts and Barclays Capital.

In addition, a shift in the asset mix away from more liquid and less capital intensive instruments towards riskier assets has also impacted significantly on the group's capital position, with the Tier 1 capital ratio declining to 7.6% of risk-weighted assets in 2003 from 9.7% 12 months earlier, partially reflecting management's desire to operate with a more efficient capital structure in the future.

Should these developments continue or the housing market take a turn for the worse, we would expect the senior debt rating of B&B to be lowered by one notch. Covered bond instruments, however, should be protected at current levels by the various structured features that are described in the following section.

# Key Features of B&B's Structured Covered Bonds

Figure 5: Structure of the Transaction



Source: B&B.

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 B&B 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. In more detail:

- B&B 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 B&B.
- The proceeds raised through the issue of covered bonds will be on-lent through an intercompany loan to B&B Covered Bond LLP (LLP) – a limited liability partnership incorporated in England and Wales, legally independent from B&B but consolidated in its accounts. In turn, the LLP will use these proceeds to purchase from B&B 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 (again, see later).
- Assets eligible for inclusion in the asset cover pool are:
  - Residential mortgages granted in England.
  - Substitution assets, which include gilt-edged securities, demand and time deposits plus government securities or RMBS rated *Aaa/AAA/AAA* and with

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residual maturity of less than 12 months. All these assets have to be denominated in GBP.

- LLP will provide a guarantee to covered bondholders for the payment of interest and principal, which becomes enforceable if B&B defaults, the bank is served an Issuer Acceleration Notice by the Bond Trustee 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 bondholders, the Security Trustee 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 both before and after an issue of covered bonds, as well as an Amortisation Test (see below). A breach of the Asset Coverage is an event of default for B&B, 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.
- B&B plc will act as the servicer under this structure as well as the interest rate swap provider, acting as counterparty for LLP, which aims to match the interest received from the mortgages in the asset cover and those payable on inter-company loans. B&B will also provide cash management services to the LLP and monitor compliance with the Asset Coverage and Amortisation Tests.

**B&B's default does not trigger acceleration...**

In the event of default of B&B, 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.

**... 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 B&B, 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 B&B 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 B&B 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

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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 9%.

## Amortisation Test

The Amortisation Test has been introduced to ensure that if B&B 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.

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