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# Covered Bonds vs RMBS: An Issuer's Perspective

Robert Plehn – Head of Securitisation and Covered Bonds  
HBOS Treasury Services

Marcus Evans Covered Bond Conference  
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# HBOS plc - financial services group

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**HBOS plc is a diversified financial services company providing predominantly retail services, corporate banking and business banking in the United Kingdom**

- Active in the fields of mortgages, personal loans, business loans and financing, long-term savings, consumer credit, insurance, liquidity and risk management and the sale of treasury products
- No 1 UK mortgage market share of 22% (£201bn)
- No 1 UK savings market share of 16.0% (£113bn)

*Source: HBOS plc Interim Results 2005*

	December 2005		
	1		

# HBOS plc financial highlights

• Total assets:	£509.5 billion	*
• Customers	over 20 million	
• Funds under management	£91.0bn	
• Capital ratios – Tier 1 (& total)	8.1 (12.7)%	
• Banking cost:income ratio	40.0%	
• Group cost:income ratio	41.8%	
• Net Group interest margin	180bps	

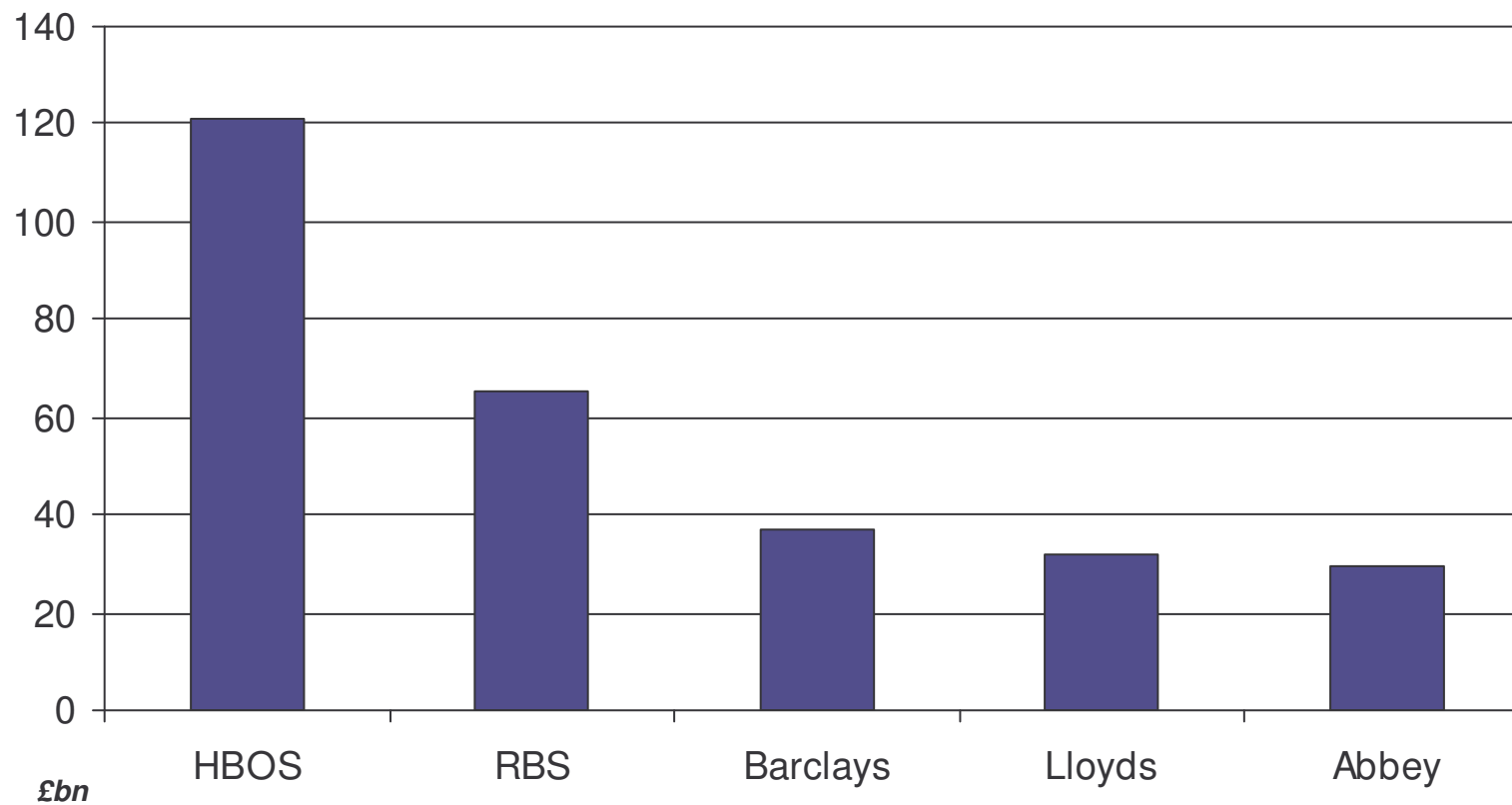
## HBOS credit ratings

	Moody's		S&P		Fitch	
	Short term	Long term	Short term	Long term	Short term	Long term
<b>HBOS Treasury Services</b>	<b>P-1</b>	<b>Aa2</b>	<b>A-1+</b>	<b>AA</b>	<b>F1+</b>	<b>AA+</b>
HBOS plc	P-1	Aa2	A-1+	AA-	F1+	AA
Bank of Scotland	P-1	Aa2	A-1+	AA	F1+	AA+
Halifax plc	P-1	Aa2	A-1+	AA	F1+	AA+

\* Source: HBOS plc Interim Results 2005

# Loans/advances to customers less deposits – UK market

2004 finals



Source: 2004 annual reports

# HBOS – A distinct asset-backed issuer in the UK

## Top 5 UK Clearing Banks

(by assets 2004 €'bn)

Rank	Group	Value
1	HSBC	1,277
2	RBS	583
3	Barclays	522
4	<b>HBOS</b>	<b>443</b>
5	Lloyds	225

## Top 5 Structured Finance Issuers\*

(by value 2004 €'bn)

Rank	Group	Value
1	<b>HBOS</b>	<b>24.63</b>
2	Northern Rock	17.47
3	Abbey National	5.99
4	GMAC-RFC	4.12
5	Bradford & Bingley	2.00

\* Source: International Securitisation Report

# HBOS Group term asset-backed finance programmes

Programme	Start Date	Asset Class	Outstanding debt* (Sterling Equivalent)
Mound	2000	UK Residential Mortgages (Self-cert and BtL)	£5.3 billion
Swan	2000	Australian Prime Residential Mortgages	£0.86 billion
Melrose	2001	UK Mid Cap Corporate Loans	£2.25 billion
Permanent	2002	UK Prime Residential Mortgages	£29.5 billion
UK Structured Covered Bond	2003	UK Prime Residential Mortgages	£10.2 billion
UK Structured Covered Bond	2004	UK Social Housing Loans	£1.0 billion
Candide	2005	Dutch Prime Residential Mortgages	£1.0 billion
Prominent	2005	UK Commercial Property Loans	£1.0 billion

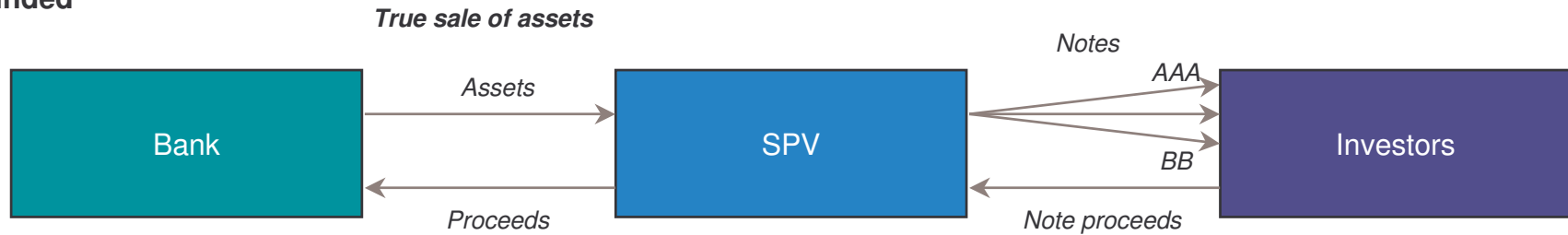
- **Potential programmes for 2006-2007**

- credit cards
- SMEs
- specialist mortgages
- Auto loans

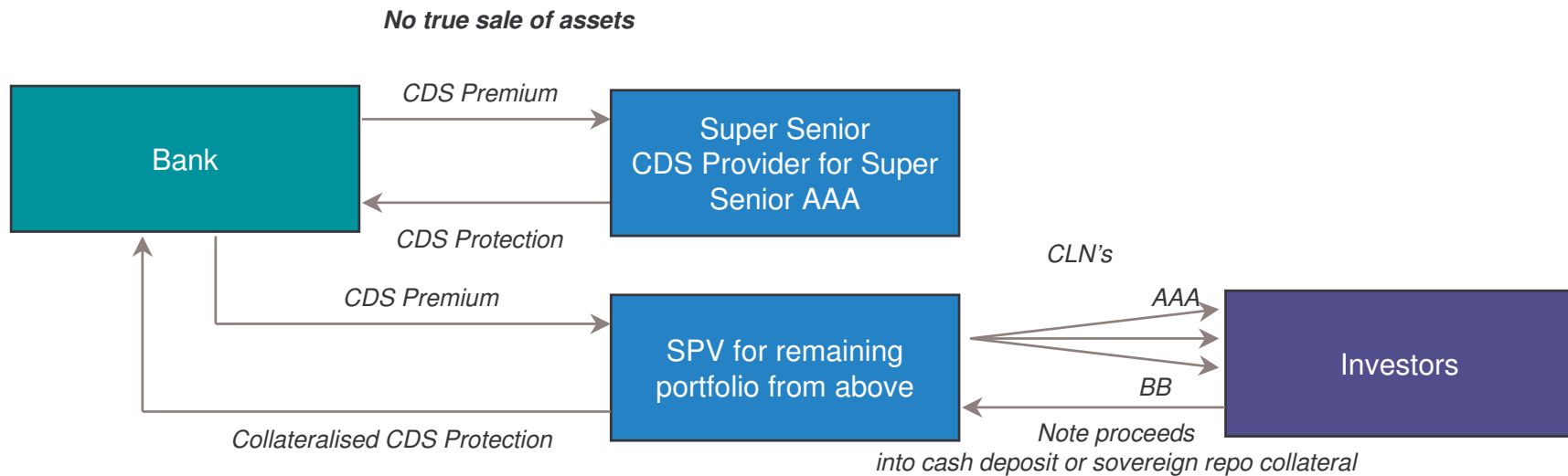
\* As at 30 November 2005

# Funded vs. Synthetic Securitisations

## Funded

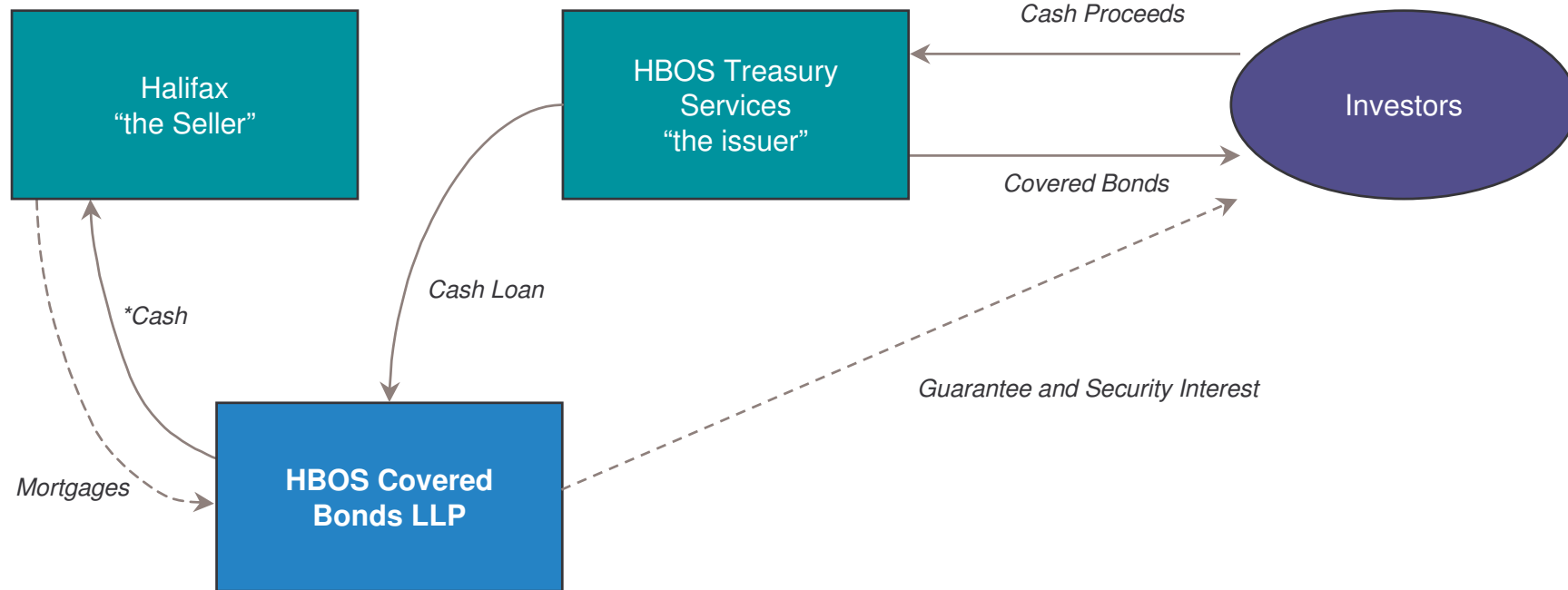


## Synthetic



	Funding	Capital Relief
Traditional Funded Securitisation	☐	☐
Synthetic Securitisation	☐	☐

# UK Covered Bond structure



*\*includes Capital Contribution + Deferred Consideration*

The capital contribution represents the amount of over-collateralisation contributed by Halifax for the benefit of investors

HBOS Treasury Services issues Covered Bonds and is legally obliged to pay interest and principal. The LLP guarantees the Covered Bonds and grants a security interest over its assets in favour of investors.

# Asset-backed funding objectives for HBOS

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## Pre-Basle II

- Primary - funding
  - diversification
  - lengthening the maturity profile
  - cheaper (if taking into account the regulatory capital benefits)
- Secondary - regulatory capital relief (securitisations only)
  - Do synthetics make sense in this market?

## Post-Basle II

- Primary - funding
  - will we issue securitisation sub-AAA?
  - where will our AAA RMBS price?
- Potential regulatory capital relief on lower quality assets
- Transactions for management of economic capital

# Securitisation vs. Covered Bonds

	Securitisation	Covered Bonds
Diversification from unsecured debt investor base	✓ ✓	✓ ✓
Large issuance amounts	✓ ✓	✓
Lengthens the maturity profile	✓	✓ ✓
Liquid instrument	✓	✓ ✓
Cheaper funding	✓	✓
Ease of execution	x	✓
Capital relief	✓	x (could be increased at high issuance levels)

# UK Regulatory issues concerning Covered Bonds

- Last year, the industry held discussions with the FSA, in a effort to get Covered Bonds recognised in the regulatory framework.

## Discussion topics with FSA – Issuance Limitations

- Liquidity benefits of covered bonds
  - Additional benefits recognised by the FSA
- Gearing effect on unsecured depositors through covered bond issuance
  - Loss given default increases marginally for unsecured creditors
  - Extent of market downturn required before unsecured borrowers are adversely affected by one notch downgrade
    - › Loss severity only increases in situations that have yet to occur
- Following these discussions the FSA confirmed in August that:
  - banks should inform their supervisor once total covered bond issuance exceeds 4% of total assets;
  - an upper benchmark limit of 20% of total assets will be applied with banks exceeding this limit likely be subject to an increase in their Individual Capital Ratio

# Risk weighting of Covered Bond investments

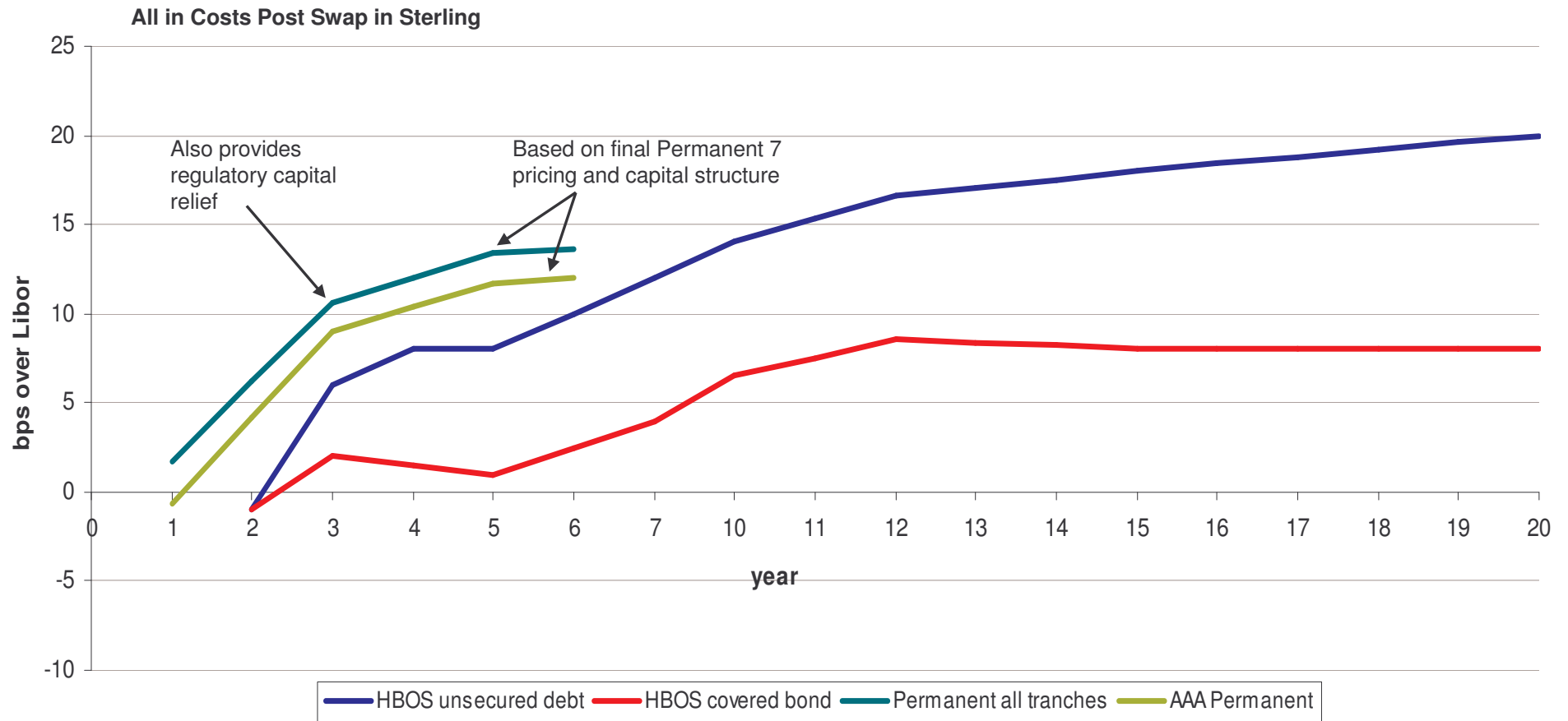
## Risk weighting of UK covered bonds

UK covered bonds are currently not eligible for a 10% risk weighting and are weighted at 20% as bank debt

- According to current Article 63(2) of the EU Banking Co-ordination Directive, member states are permitted to ascribe a 10% risk-weighting to securities that comply with Article 22(4) of the UCITS Directive
- Under Article 22(4) a “covered bond” must be issued by a credit institution which has its registered office in a Member State.
  - Who is the competent authority – Parliament or FSA?
- The latest draft of the EU Capital Requirement Directive provides a definition of “Eligible Assets” for covered bonds. Must still meet the UCITS definition of “covered bonds”
- How important is the regulatory risk weighting in a Basel II world?
  - is the investor a bank?
  - if so, is the bank following?
    - › Standardised approach – dependent upon definition as a “covered bond” and rating of sovereign or issuer (i.e. must be AAA to AA- for 10%, A+ to A- for 20%, etc.) – only situation where CRD definition matters
    - › IRB Foundation Approach – Supervisor mandated formulaic approach – ED, M, PD and LGD (still unclear) with PD being the variable based on rating – for HBOS AAA covered bonds still unclear but could be as little as 3% risk weighted – CRD definition irrelevant
    - › IRB Advanced Approach – same input factors but all factors determined by the investing bank as opposed to regulator with issuing banks having to provide LGD numbers to investors – could result in even lower risk weighting for good quality asset pools – CRD definition irrelevant

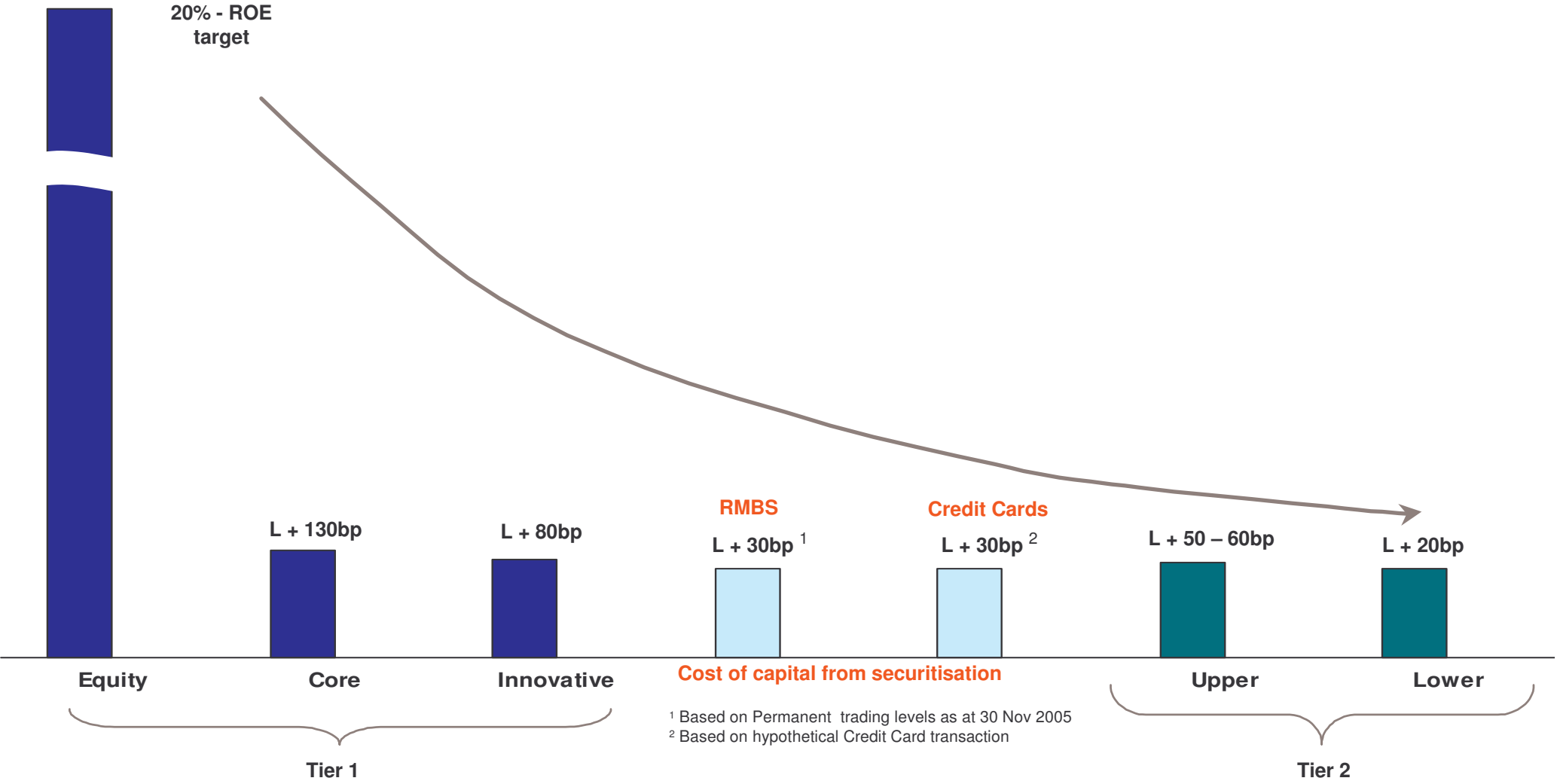
# HBOS funding perspective

Snap Shot of Projected Current Debt Issuance Pricing as of 25/11/2005



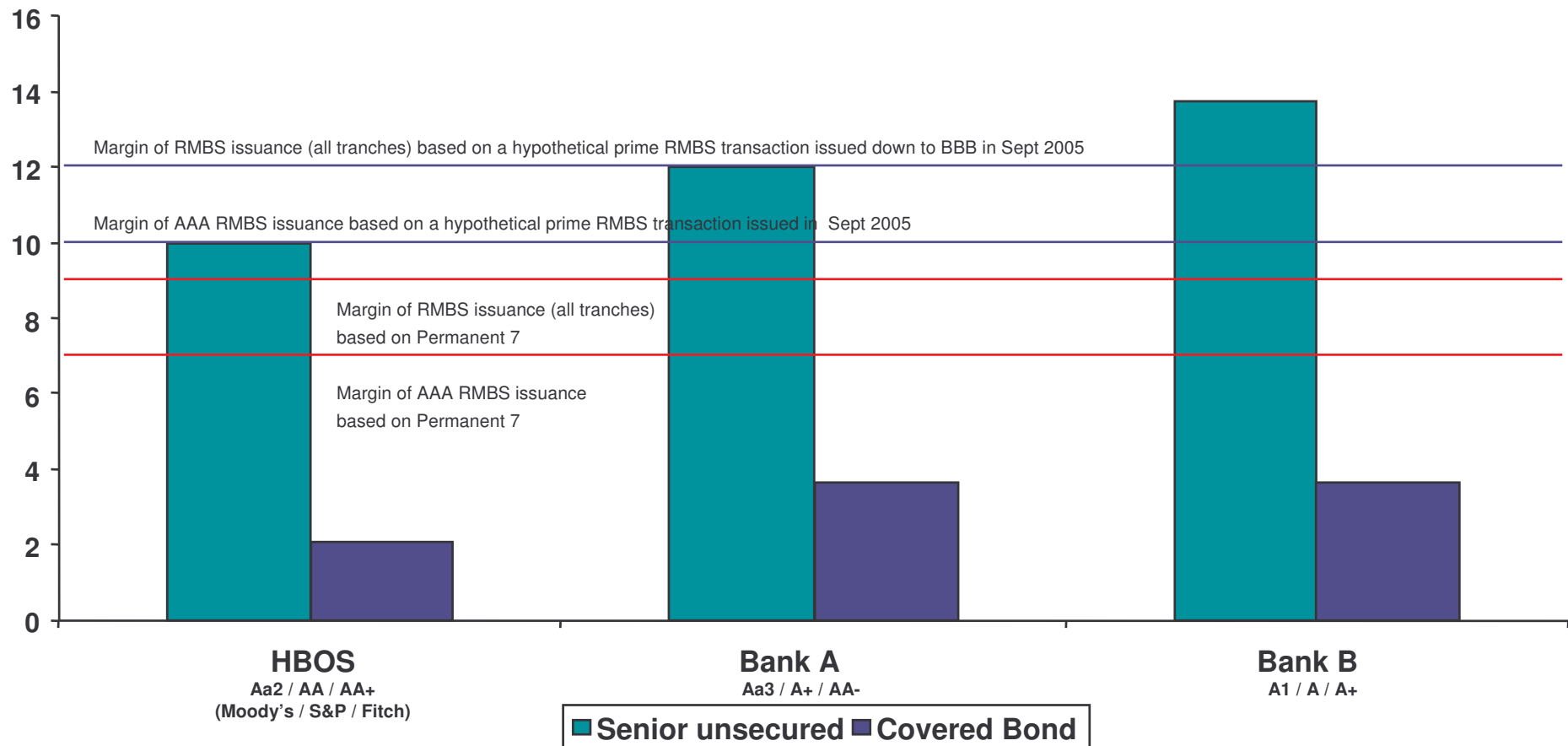
# HBOS capital perspective

Estimated cost of capital issuance



# What's the funding forecast

## Estimated costs on 5-year debt\*



\* As at December 2005

	December 2005		
	14		

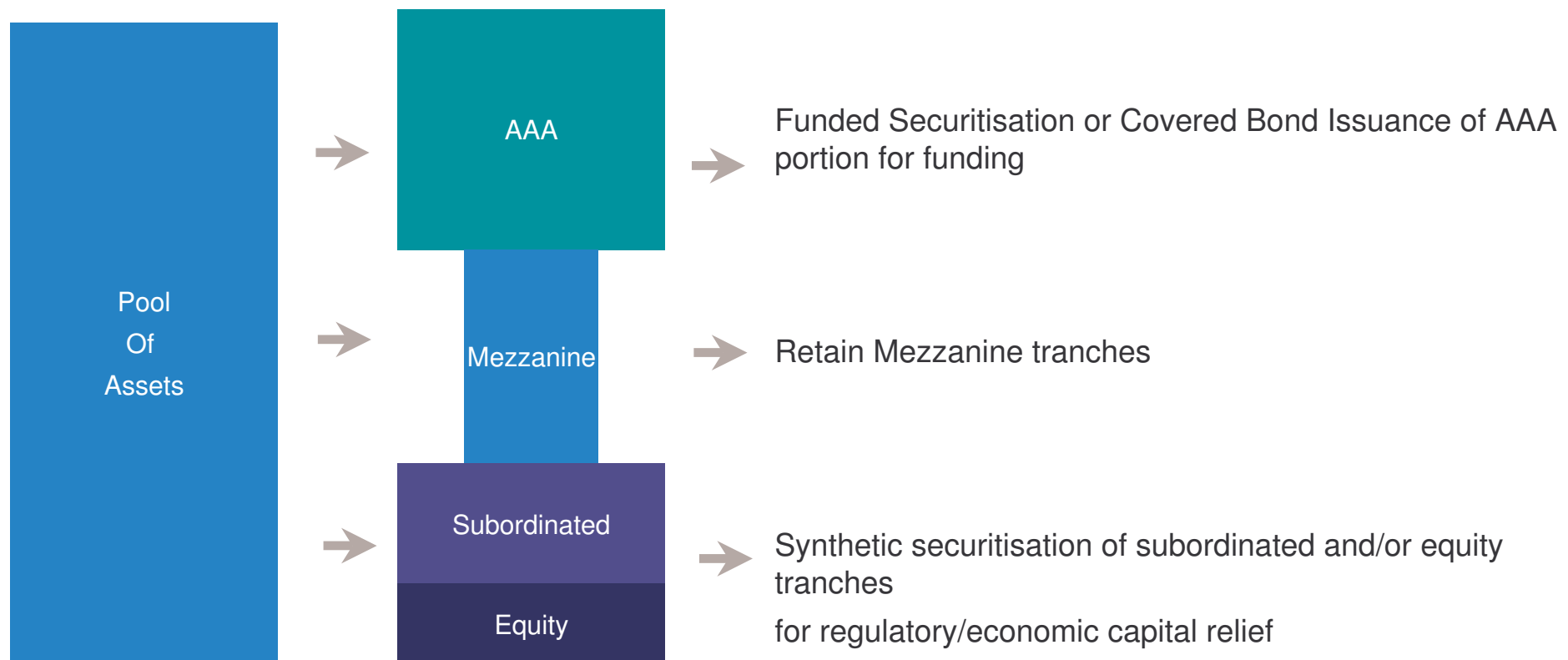
# The Future – more of the same or changes in strategy

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- Depends on the objectives/needs of each issuer
- General conclusions
  - Securitisation will not provide regulatory capital relief on prime RMBS portfolios
  - Synthetic, regulatory capital relief transactions will disappear in respect of many asset classes unless there is a desire to cap regulatory capital volatility
  - Securitisations for funding purposes should continue but fully funded structures down to BBB and below will only be attractive to institutions that are lower rated and have limited sources of AAA funding
  - Regulatory concerns may place some limits on covered bond issuance
- Securitisation programmes will complement covered bond programmes
  - diversification of investor base
  - issuance size limitations on covered bonds
  - asset advance rate efficiency
  - delinkage issues - ability to issue in difficult markets
- Generally more slicing and dicing

# Possible changes to asset-backed funding/risk management

- In the future, a barbell approach may be more apt for some issuers – a mixture of funded and synthetic securitisation



# Examples of the move to the future

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- Efficient funding
  - MTN programmes for RMBS
- Economic Capital Management through synthetic transactions
  - ING
    - › MARS – SME CLO
    - › Memphis I & II – prime Dutch RMBS
  - Northern Rock
    - › Whinstone
- Slicing/Dicing the same portfolio
  - Northern Rock
    - › Covered Bonds
    - › Provide Graphite 05-1 synthetic RMBS
  - Egg
    - › Provide Release 03-1 synthetic RMBS
    - › Cronos RMBS 2005 – AAA only funding

# Thoughts for the future

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- Not all issuers are the same – their future asset-backed issuance strategy will depend on a number of market factors and factors individual to the issuer (e.g. comparative cost to unsecured debt, availability of assets for AAA funding etc.)
- Most major takers of wholesale funds from the asset-backed capital markets will continue to rely on both securitisation and covered bonds issuance
- Covered bonds and securitisation will continue to be complementary funding strategies with each accessing different investor bases although a cross over is occurring
- Securitisation of prime residential mortgages will no longer provide efficient capital relief for large, highly rated institutions and this will mean these types of securitisations will essentially become funding exercises.
- Securitisation for capital purposes will become more of an economic capital management exercise as regulatory capital and economic capital measurements become more aligned.

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