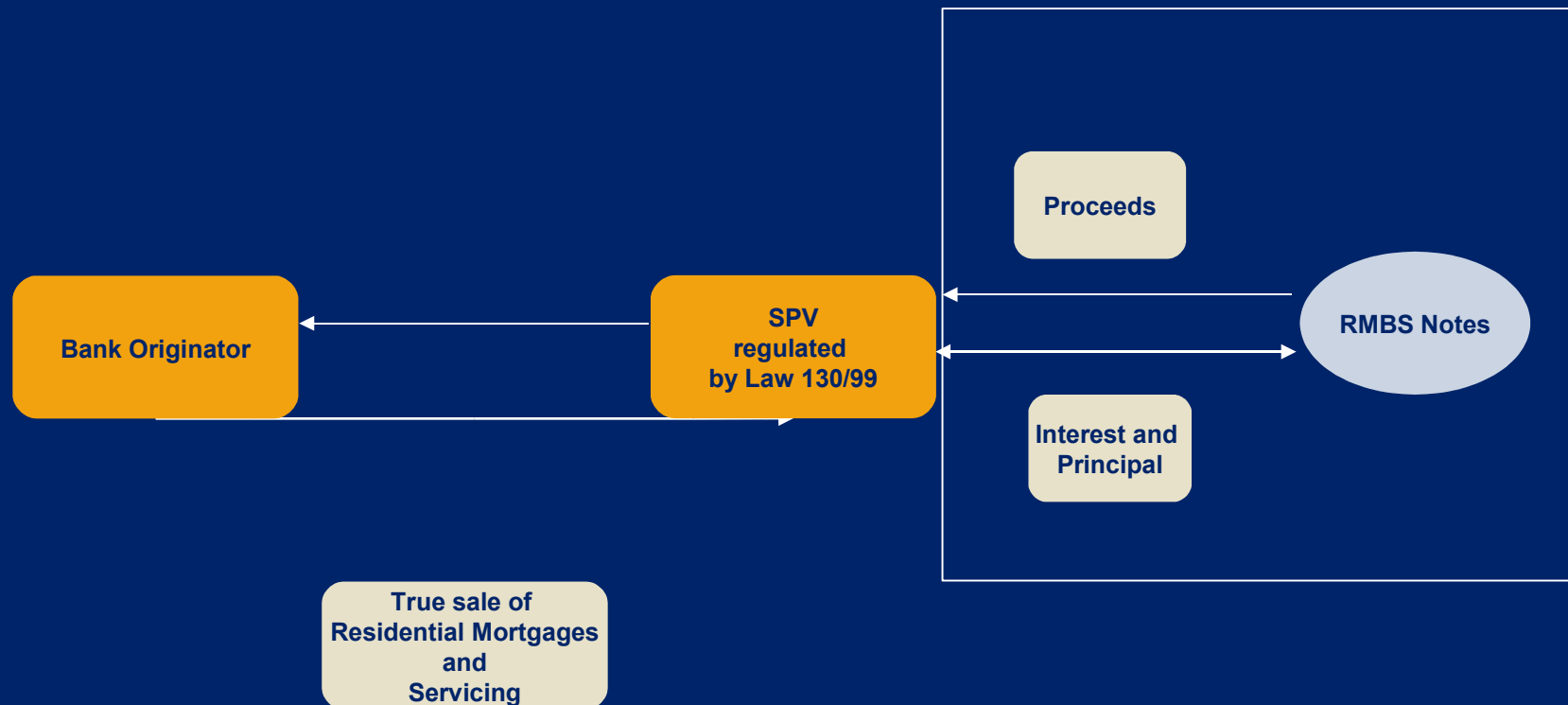


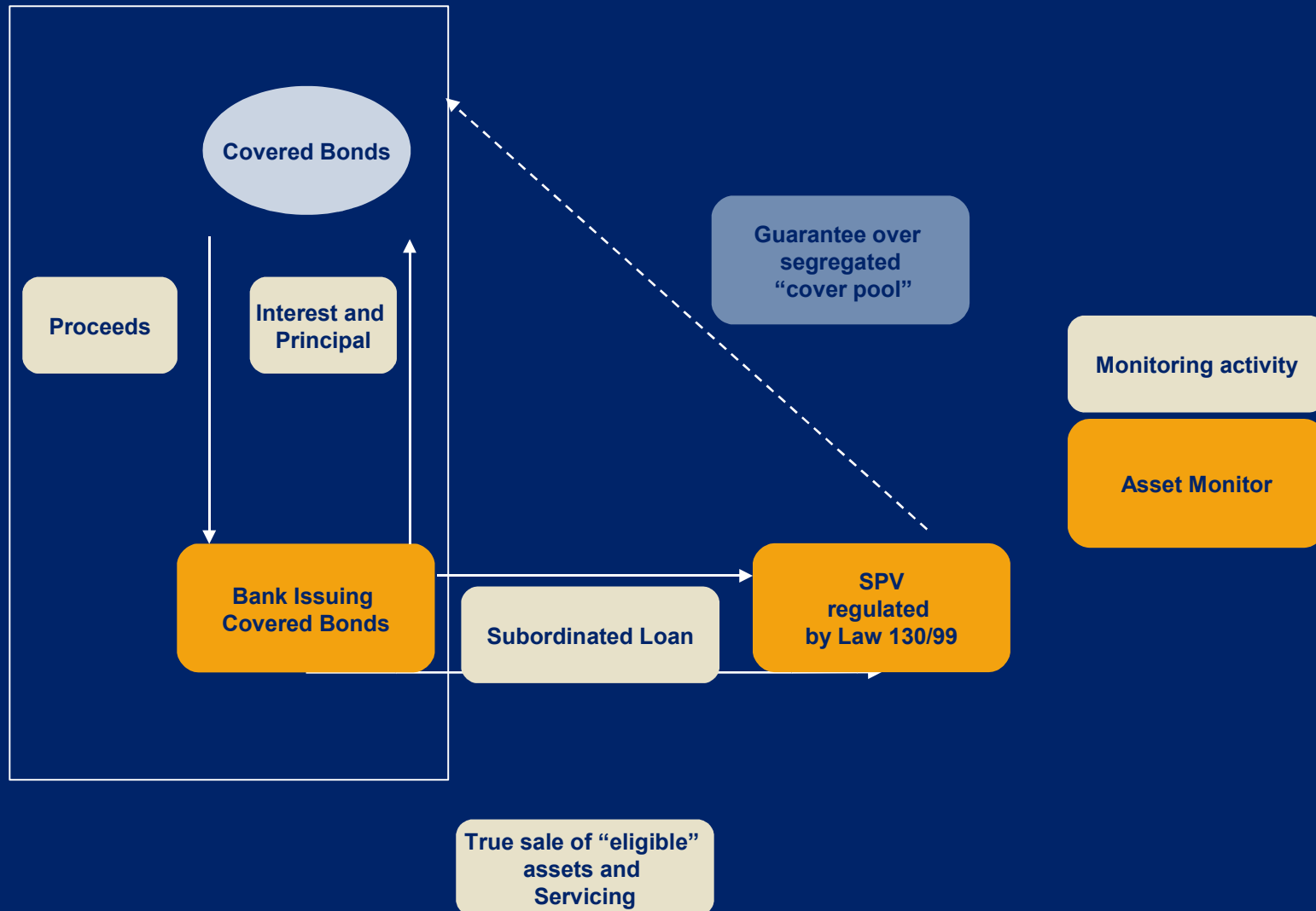
Covered Bonds vs MBS: a comparison

Fulvio Pelargonio

RMBS Structural Diagram



Italian Covered Bonds Structural Diagram



What Are the Differences between CB and RMBS?

The Investor's Perspective

Italian Covered Bonds

- Issuer is the operating entity (issuing bank)
- Double protection: full recourse to the issuer and to a high-quality pool of collateral assets
- Higher liquidity due to size (Jumbo covered bonds) and specific secondary market commitment
- Dynamic cover pool monitored by independent entity (Asset Monitor)
- Secured by highly rated public sector credits and/or low LTV mortgage loans
- Only one highly-rated tranche (usually AAA) – no equity piece or lower-rated tranches
- Normally hard-bullet, fixed rate structures
- 10% BIS weighting
- Analysis of the legal framework is required only once; thereafter only cover pool analysis required
- Strong incentives for other issuers to bail out any troubled covered bond issuer
- Issuer's credit history still matters

Residential Mortgage Backed Securities

- Usually FRN soft-bullet tranches
- Extension/WAL risk
- Issuer is a special purpose vehicle (SPV)
- Direct claim on specific assets but not against the issuer
- Less liquid than covered bonds but yield pick-up compared to covered bonds
- Static asset pool (sometimes revolving)
- Variety of possible asset classes
- Different tranches with different risk/ratings
- Often soft-bullet structures due to prepayment risks / controlled amortisation
- BIS weighting goes with underlying asset
- ABS/MBS products are rather complex,
- Strength of origination only relevant as servicer

What Are the Differences between CB and RMBS? (Cont'd)

The Issuer's Perspective

Italian Covered Bonds

- Timing and flexibility of an EMTN program
- No capital relief since the cover assets remain consolidated by the issuer
- Significantly cheaper funding level (but requires high-quality assets)
- Significantly longer tenors (10, 15, 20 yrs)
- Can be collateralised by a wide range of eligible assets (but limited to those):
 - **First lien Residential Mortgages with LTV <80%**
 - **First lien Commercial Mortgages with LTV <60%**
 - **Exposure to AA rated EEA Public Sector entities**
 - **up to 10% of EEA Public Sector Entities**
 - **Senior tranches of ABS with minimum 95% of the collateral made of eligible assets**
- Servicing remains within the originator (except in case of bankruptcy)
- Limited regulatory requirement on Law. 130 SPV to be set up according to art. 7-bis (no need for art. 107 TUB)

Residential Mortgage Backed Securities

- Capital relief for ABS/MBS as the assets are transferred from the originated balance sheet into a SPV. However, Basle II & CRD will reduced this advantage
- Flexible funding tool which enables to fund a variety of quality and types of performing /non performing asset classes
- Significantly higher cost of funding associated with capital relief
- Externalisation of servicing activities (in some cases)
- Need of more detailed reporting
- No need for Jumbo size
- Longer executing time due to:
 - stand alone issuance
 - portfolio selection and definition of “blocco”
 - Rating Agencies involvement
- Expected to require higher credit enhancement
- Soft-bullet FRN funding

Pros and Cons between CB and Senior Unsecured?

The Issuer's Perspective

Italian Covered Bonds

- Mainly Fixed Rate Bullet structures
- Mainly longer (>5 yrs) maturities
- Secured by *Cover Pool*
- New investor base

- Significantly cheaper funding level (but requires high-quality assets)
- Possibility of longer term issuance (10, 15, 20 yrs)
- External cover pool asset monitoring (by a independent auditor)

- Need for a Servicing activity
- Need for double-accounting capabilities
- Limited regulatory requirement on Law. 130 SPV to be set up according to art. 7-bis
- Involvement of Rating Agencies

Senior unsecured

- Mainly FRN
- Mainly 2,3, 5 and 7 yrs maturities
- Opportunistic funding
- Consolidated investor base

- Execution Speed
- No formalities
- Limited due diligence required
- No specific regulatory requirements
- Private placement

- More expensive funding
- Shorter maturities
- Worse tool for ALM

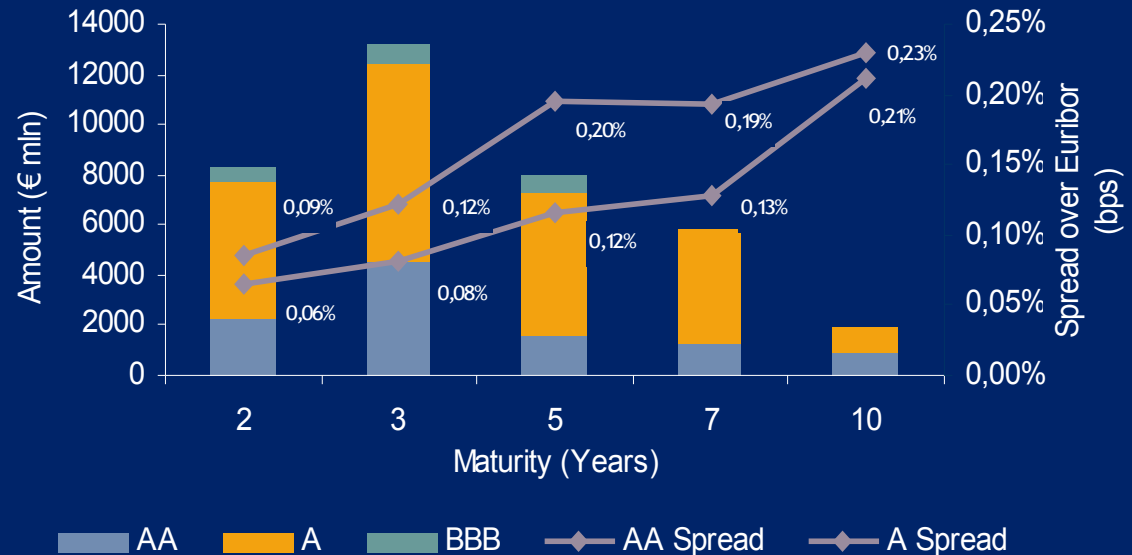
The Senior FRN Market – What Happens in Italy in Comparison to Spain

- In Italy, the majority of 2006 FRN were A-rated.
- Most transactions had a tenor up to 5 years.
- In Spain, short to medium tenors were dominated by senior FRN issues
- Medium to long maturities were funded by CB (Cédulas), on average, 10 to 15 bps cheaper than AA for the same maturities.

What is Next in Italy?

- We expect a similar trend for Italian FI that will soon be able to access significantly cheaper and longer funding through CB
- As for Spain we expect Italian FI's funding mix to show a significant shift from FRN to CB and for certain asset classes from ABS to CB

2006 Volumes and Spreads for Italian Senior FRN

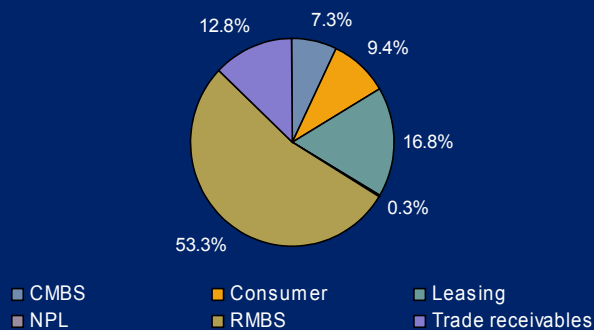


All Senior FRN Deals with Amount over €100mln for Italian Financial Institutions

What Happens in Italy in Comparison to Spain

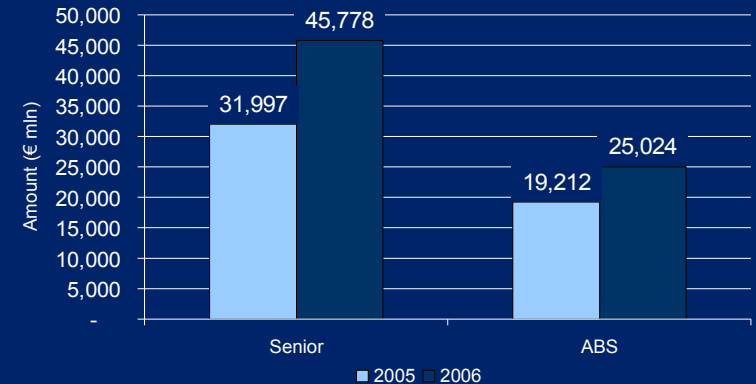
- Italian FI currently satisfy their capital markets funding need through a mix of Senior (65%) and ABS (35%)
- Spanish FI, having access to a wider set of tools, show a very different funding mix : Senior (39%), CB (31%) and ABS (30%)
- Growth rates are also different. In Italy, Senior bonds grew at a higher rate than ABS, while Spain showed similar rates of growth for the three funding tools.

Breakdown of 2006 Italian ABS



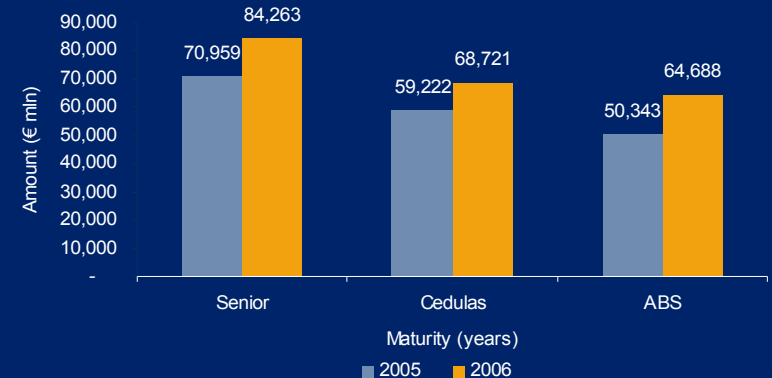
Source: RBS

All Italian Funding Issuance - 2005, 2006



Source: Dealogic Bondware, RBS

All Spanish Funding Issuance - 2005, 2006



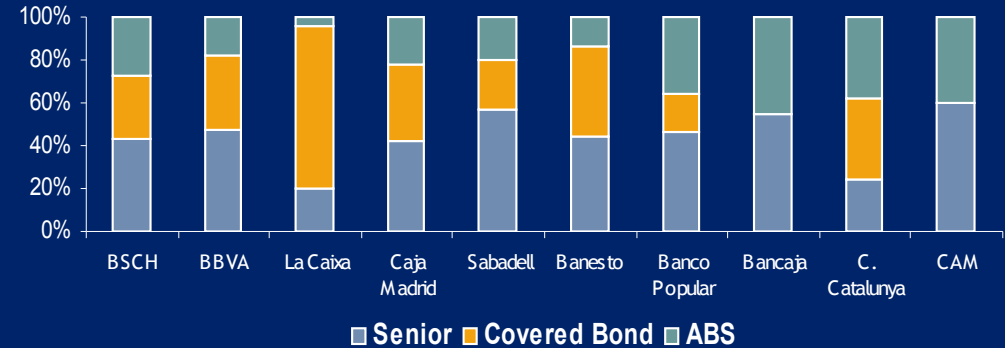
Source: Dealogic Bondware, RBS

The Spanish Experience: Case Study

The Top 10 Spanish Banks

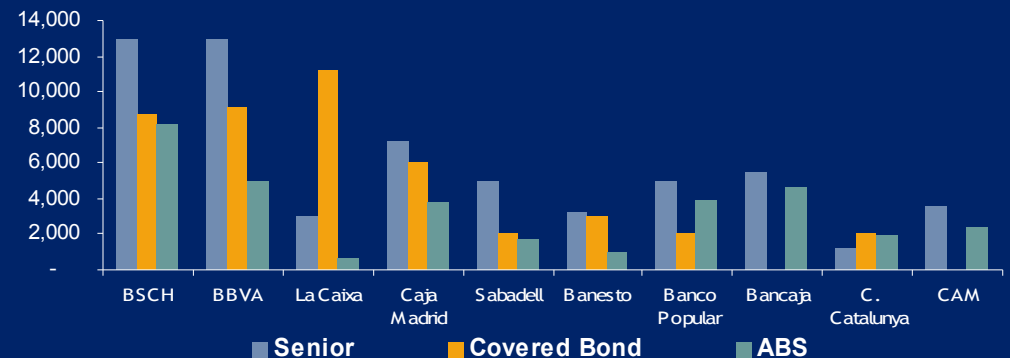
- CB played an important role in their 2006 funding strategy.
- Senior transactions represented the majority of the funding mix, almost reaching €60 bln
- CB volumes for top 10 Spanish banks were greater than €44 bln, representing 32% of their total funding
- ABS issuance was close to €33 bln, representing 24% of their total funding

Funding Mix for Top 10 Spanish Banks - 2006



Source: Dealogic Bondware

Funding Issuance for Top 10 Spanish Banks – 2006



Source: RBS (senior FRN 7 yrs transactions lead managed by RBS)

What Could Happen in Italy

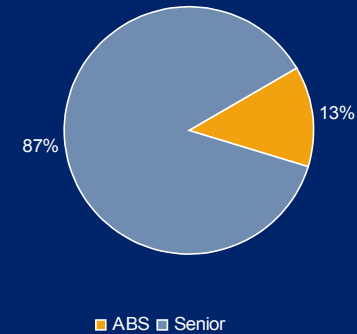
- Current FI capital markets funding mix is covered almost 90% by senior FRN
- Only 13% by off-balance sheet securitisation transactions showing a different trend from Spain and EU
- Current funding mix highlights the structural lack of long-term funding tool

- Current funding mix for top 10 Spanish banks may be a good prevision of what could happen in the Italian FI funding mix in the medium term

- With the introduction of CB we expect the new funding tool to replace the majority of long-term funding

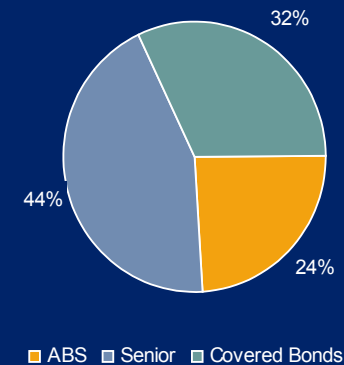
- Basel II is likely to incentivize the use of securitisation technology to free-up regulatory capital use therefore increasing the issuance of ABS

Funding Mix of the Top 12 Italian Banks - 2005-2006



Source: *Dealogic Bondware*

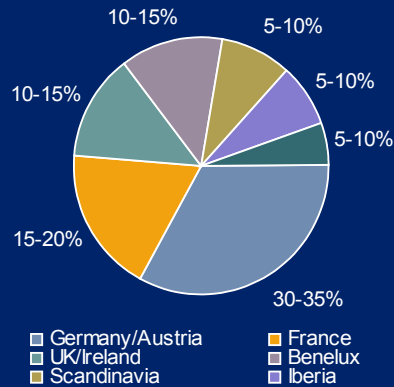
Funding Mix of the Top 10 Spanish Banks - 2006



Source: *Dealogic Bondware, RBS DB*

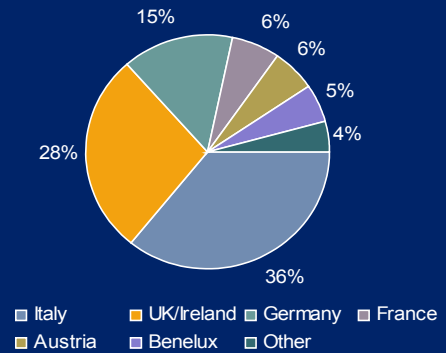
Investor Base for Italian FRN > 5yrs Tenor and Cedulas

Investor Base by Country - Spanish Cedulas - 2006



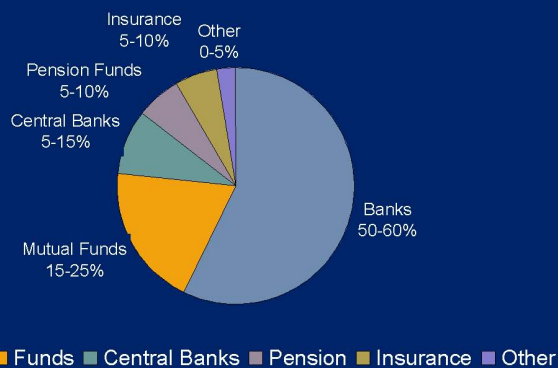
Source: Euroweek, IFR, RBS

Typical Investor Base by Country - Italian Senior FRN 7yrs



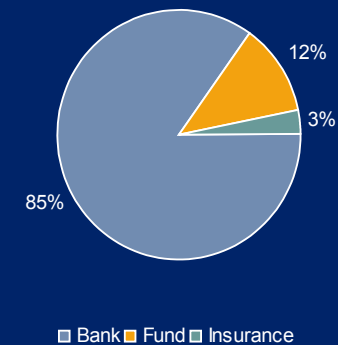
Source: RBS

Typical Investor Base by Investor Type – Spanish Cedulas 2006



Source: RBS

Typical Investor Base by Investor Type - Italian Senior FRN 7yrs

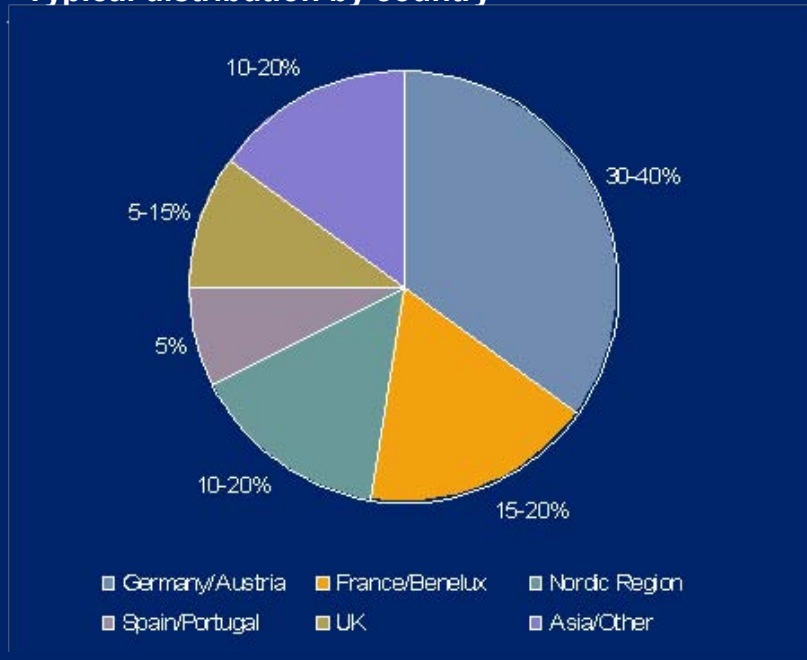


Source: RBS

Breakdown of Covered Bond Distribution

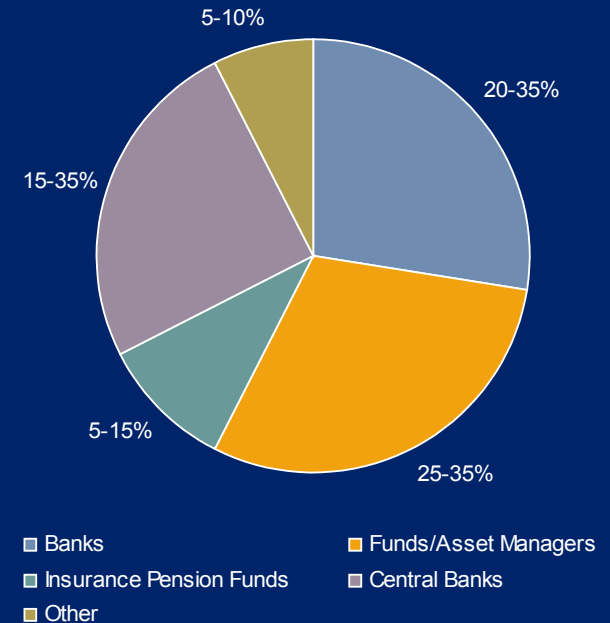
- Germany, France and Benelux buy usually half of Jumbo covered bond issues
- Asia accounts for 10 to 20% of the demand
- Central banks are often the largest segment followed by funds & asset managers and banks
- Insurance companies & pension funds usually take between 5 and 15%

Typical distribution by country



Source: RBS, Euroweek, dealogic, ifr

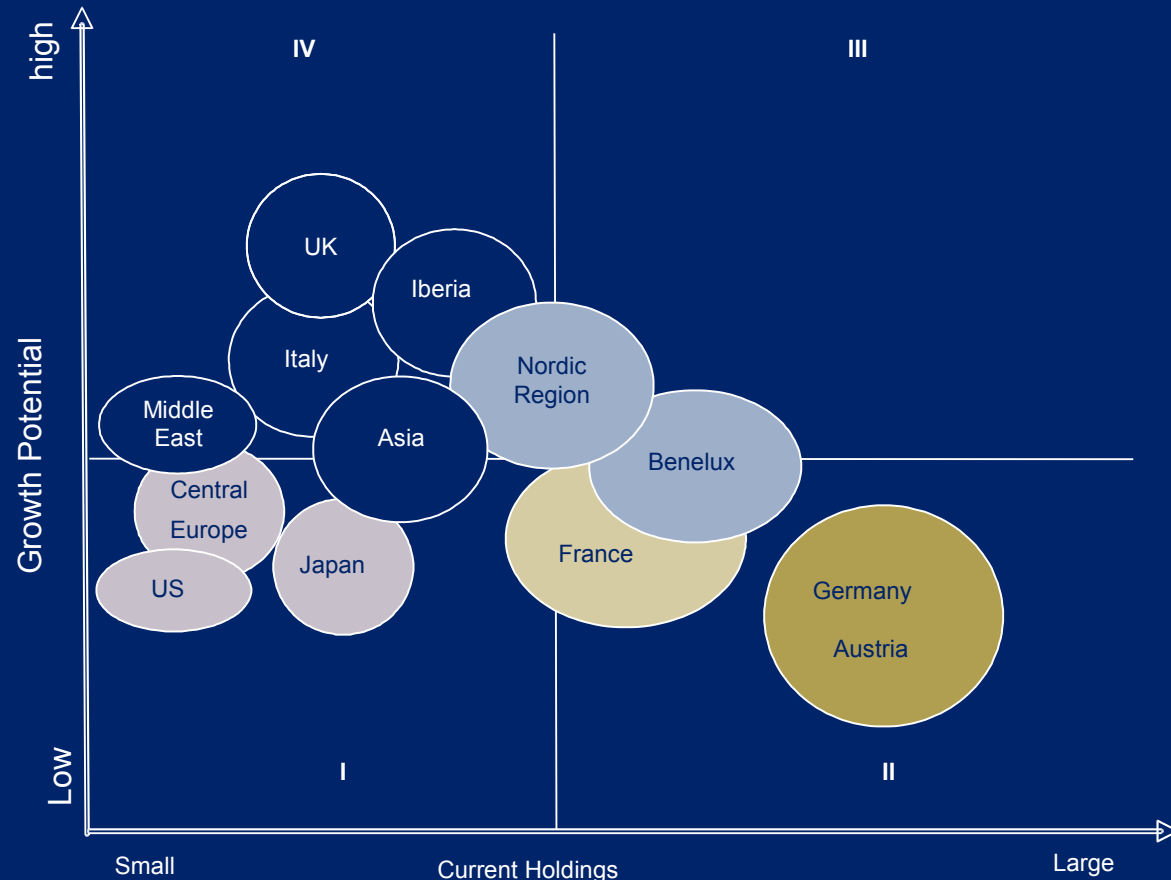
Typical distribution by type of investor



Source: RBS, Euroweek, dealogic, ifr

Cluster Analysis of the Covered Bond Investor Base

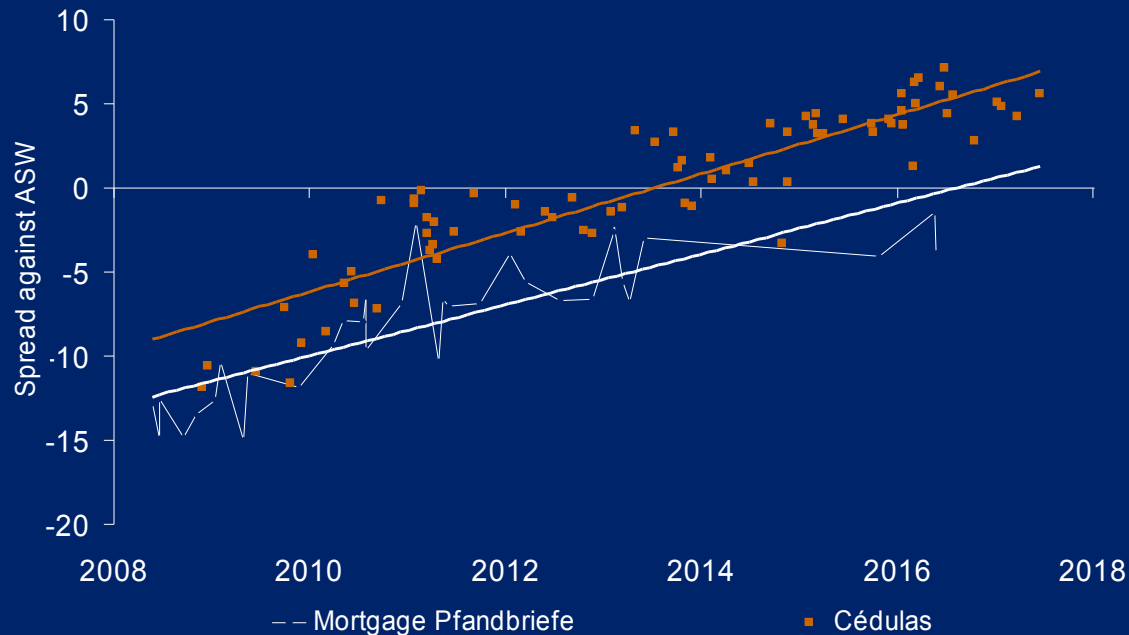
- **Germany & Austria** have a well developed investor base but further growth potential is limited
- **French** investors are strong buyers of OFs but are increasingly buying non-domestic bonds as well
- **Scandinavian** demand will be boosted by domestic issuance
- The **UK** continues to provide a substantial backbone for distribution
- **Asian** demand is still mainly driven by central banks
- **Central European** central banks are increasing Euro reserves and will play an increasingly important role
- The **US** investor base is still relatively small and proves difficult to tap



- I. Small investor holdings & low growth potential
- II. Large investor holdings & low growth potential
- III. Large investor holdings & high growth potential
- IV. Small investor holdings & high growth potential

Pricing Expectations for Italy....

- We expect that the Italian CB will trade within this range



Why Italian CB will be welcome by the market

- solid structure
- Low LTV pool
- Highly recognised names (Senior market)
- ABS technology
- Favourable rating agencies assessment

MAIN DRIVERS FOR PRICING OF ITALIAN CB

- Strength of the legal framework
- Quality of the cover pool
- Diversification of assets
- Backed by public sector or mortgage assets
- Portion of commercial properties
- Over-collateralisation level
- Rating(s) of the issue
- Issuer ratings
- Size of the programme
- Supply and Demand considerations
- Jumbo size/market maker commitment
- Maturity of the bond
- Risk weighting under Basel II/CRD