STANDARD & POOR'S

*Structured Finance*

# PRESALE REPORT

*This presale report is based on information as of March 8, 2000. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings. Please call Standard & Poor's at (44) 171-826-3540. for the final ratings when assigned.*

## Island Finance (ICR4) S.p.A.

Eur420 million floating-rate notes

**Preliminary ratings as of March 8, 2000**

| Class | Preliminary rating* | Preliminary amount (Mil. Eur) |
|---|---|---|
| A | AAA | 237.3 |
| B | AA | 71.3 |
| C | A | 42.8 |
| D | BBB | 28.6 |
| E | BB | 40.0 |
| Deferred purchase price ** | N.R. | 178.0 |

*The rating of each class of securities is preliminary and subject to change at any time.
** The deferred purchase price is repaid to the seller only once all rated notes are redeemed.

### Profile

**Expected closing date:**
March 24, 2000.

**Collateral:**
A portfolio of non performing loans originated by Banco di Sicilia S.p.A. in Italy.

**Underwriter:**
Morgan Stanley Dean Witter; Mediocredito Centrale

**Seller:**
Banco di Sicilia S.p.A.

**Master servicer:**
KGI Corso Venezia S.r.l.

**Special servicer:**
KGI Corso Venezia S.r.l. and Servizi Immobiliari Banche S.p.A. (SIB).

**Trustee:**
Bankers Trust Co.

**Fiscal agent:**
Bankers Trust Co.

**Cap provider:**
Deutsche Bank (AA/A-1+).

**Liquidity provider:**
To be decided.

**Loan administrator:**
Banco di Sicilia S.p.A.

**Analysts:**
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### Rationale

The preliminary ratings assigned to Island Finance (ICR4) S.p.A.'s euro (Eur) 420 million floating-rate notes issuance reflect the expertise of KGI Corso Venezia S.r.l and Servizi Immobiliari S.p.A. (SIB) in the servicing of NPL (non-performing loan) portfolios and its established track record; the servicer compensation structure geared at maximizing the pace and amount of recoveries, and the valuation of the real estate collateral of the mortgage portfolio by SIB.

Further key considerations include:

- The diversification of the portfolio by property types;
- The regional concentration of the portfolio in Sicily;
- The preliminary ratings on the class A, B, C, and D notes address timely interest and final principal repayment; and
- The preliminary rating on the class E notes addresses payment of accrued interest and final principal at legal maturity.

### Transaction Summary

***Strengths***

Listed below are the key strengths of the transaction, the management, corporate overview, and equity behind it, and its financial highlights.

- *Large portfolio*. With over 3,490 assets the portfolio is well diversified by property type with average loan balance approximately Eur395,000 and no obligor accounting for more than 2% of the portfolio;
- *Predominantly residential*. Approximately 45% of the portfolio consists of residential properties. These are the more stable asset class and benefit from greater availability of potential buyers;
- *Secured on real estate*. Virtually all of the projected cash flow arises from mortgage assets;
- *SIB experience in Italy*. SIB's 14 years of experience in the Italian market, and its expansive network of brokers, make it uniquely qualified to manage and liquidate this NPL portfolio;
- *SIB and KGI Corso Venezia compensation incentives*. The servicer uses a compensation structure which provides performance-based incentives to increase

both the amount and the pace of recoveries. Part of the incentives is paid to SIB management; and

- *KGI Corso Venezia.* The entity that oversees the management and liquidation of the portfolio combines extensive experience in Italy, having managed three prior securitizations to date for the Morgan Stanley Real Estate Fund starting in 1997.

#### *Concerns*

The concerns highlighted during the rating process are as follows:

- *Concentration in Sicily and southern Italy*. Longer resolution times will result as courts are generally slower than in the north of Italy and borrowers have less cash available for purchases or out-of-court settlements (called discounted pay offs, or DPOs).
- *Economic conditions in Sicily*. With over 88 % of the portfolio by gross book value (GBV) in Sicily, the portfolio is subject to the risks associated with this regional economy;
- *Less seasoned loans*. Judicial action is not as advanced, as seen in other NPL portfolios. SIB/KGI Corso Venezia will initiate proceedings in approximately 22% of the mortgage portfolio (by GBV); and
- *Lack of CTUs.* Many loans do not yet have CTUs (property evaluation as required by the law). These CTUs could come in higher than anticipated and result in further timing delays.

#### *Mitigating Factors*

The factors that mitigate the transaction concerns are listed as follows:

- *Concentration in Sicily and the south.* Longer resolution times were modeled for the transaction by reducing the number of projected DPOs;
- *Economic conditions in Sicily*. Valuations of mortgaged assets have been conservative;
- *Less seasoned loans*. SIB has spent nearly 12 months performing a corporate overview on the properties and borrowers and have already developed detailed business plans for all the assets; and
- *Lack of CTUs.* As a result of the lack of seasoning and CTUs, the CTU valuation was increased relative to the SIB value, which further stressed the resolution time frame for the portfolio (*see below under Standard & Poor's Credit and Cash Flow analysis*).

### Transaction Structure

#### *Background to Securitizing Non-Performing Mortgage Loans*

Delinquent or defaulted obligations secured by mortgages on commercial or residential property (NPLs) involves very complicated workout procedures in order to recapture monies owed. Typically, debtors have ceased making payments on these loans, and consequently there is little or no cash flow being received from these assets.

To finance such a portfolio of assets through securitization requires that cash is generated through the liquidation of the credits in order to service the portfolio debt. The liquidation of the credits must be performed in an extremely timely manner and is dependent on the abilities and expertise of the entity responsible for managing the liquidation process. Such an entity, commonly referred to as a special servicer, must possess experience in formulating and executing workout strategies for mortgage loans, expertise in the relevant legal jurisdictions and real estate markets, and be given the incentive to ensure they pursue the most effective and efficient liquidation strategies.

The success of an NPL securitization is, therefore, directly linked to the special servicer's experience, competence, and motivation. The review of these competencies emphasizes the incentive structure in the evaluation of all global NPL securitizations.

***Special Servicer's Role***

In order to expedite the most favorable resolutions of NPLs, the special servicer must first craft a workout strategy based on its knowledge of the borrower's status, the collateral securing the loan, the real estate market in which it is located, and the legal status of the loan and the local jurisdiction. The workout strategy becomes the business plan, or asset resolution plan, and one is created for each asset in the portfolio.

The transfer of management of the assets to a third party special servicer is important to note because the servicer has no previous relationship with the borrower and its course of action is strictly a "bottom line business decision" unencumbered by any previous relationships.

Numerous types of workout or exit strategies may be used in formulating a specific business plan for each loan. These plans set the framework for the liquidation of the asset in terms of timing, sales price, and likely buyer. Possible strategies include foreclosure and sale through the court auction process, sale of the legal obligation to a third party, negotiation of a DPO with the debtor, and renegotiation of the terms of the obligation and the creation of a new or modified debt.

Before a plan is developed, the special servicer must determine the market value of the asset securing the loan. Asset managers, the individuals responsible for the development and execution of individual plans, must perform in-depth corporate overviews on the collateral. Any issues that may affect value or marketability must be surfaced and analyzed. Such issues in Italy may include tenants currently in occupancy, special zoning restrictions, prepaid deposits forfeited to bankrupt developers, and local political issues surrounding a property.

The special servicer must then research the submarket for sales of comparable properties, and know the local supply and demand features. Finally, the servicer uses its in-depth knowledge of real estate markets and extensive network of brokers to assess the marketability and price of the underlying collateral.

As part of the corporate overview on the Island portfolio, all property assets in the mortgage portfolio were valued. The Italian real estate market is predominantly an end-user market, with few investors buying properties solely for investment purposes. As a result, cash flow and yield valuation methodology is seldom appropriate to determine the price at which a buyer will come forward for an asset. Therefore, values are mostly determined on a comparable sale basis based on the experience and knowledge of the special servicer. (This methodology is also appropriate considering 45% of the mortgage portfolio is made up of residential properties.)

For a few of the larger commercial properties in the portfolio, such as hotels and hotel/resorts, and warehouse/distribution facilities, the special servicer creates a proforma income statement based on current market rents for similar properties and examines current yields which might be demanded by an investor for such a property. The resulting values are then compared with recent comparable sales as a reality check.

The comparable sales methodology should also factor appropriate discounts for properties which are occupied by tenants. The discounts apply primarily because of the difficulty and time involved in removing tenants. In order to accelerate the process of actually gaining tenancy, owners often make a payment to the tenant to as an incentive for the tenant to vacate. This is a common market practice in Italy, and these discounts (for occupied properties in a foreclosure situation) range from a total of 20% to 40% of open market values. Other discounts to value are typically applied to factor in the projected costs to renovate old or dilapidated buildings. These discounts are done on a case by case basis.

In Italy, once a current market value has been determined, the asset manager must reconcile this market value against several other factors that may serve to limit the proceeds realizable from the liquidation of a mortgage loan. These factors include the amount of the registered mortgage (Ipoteca), the outstanding balance actually owed (*Esposizione* are also referred to as the GBV), and how the local court appraiser might assess the collateral's value (or CTU).

The mortgage (Ipoteca) amount limits the secured collection in either a foreclosure or bankruptcy collection action. Lending practices in Italy have called for loans at amounts not to exceed 50% loan-to-value; so for many years, the Ipoteca amount recorded at loan origination was customarily 200% of the original loan balance. In recent years, a number of banking institutions have increased the amount of Ipoteca recorded to 300% of the original loan balance. This mortgage also secures additional obligations of the borrower such as accrued and unpaid interest. (If a debtor falls into delinquency, interest accrues at a penalty rate and will continue to accrue; however, all amounts that ultimately accrue in excess of the recorded mortgage amount become unsecured claims.)

Total outstanding loan balance (*Esposizione*) is the total outstanding amount due on the delinquent loan. The components of *esposizione* include the following: unpaid/not yet due principal, unpaid loan installments (principal and interest), accrued default interest, accrued (lender paid) reimbursable expenses, and periodic current interest earned between scheduled installments. Once accelerated, all of the components become unpaid and due principal with on-going interest earned at the default rate.

The CTU valuation is a process whereby the court overseeing the foreclosure action requests a local real estate professional to perform a valuation of the real estate collateral pledged to secure a given loan. When the CTU is received by the court and accepted as to its integrity/accuracy, the valuation becomes the reserve price for the first foreclosure auction set by the court for disposition of the real estate collateral.

After comparing the market value of an asset with these constraining factors, the special servicer will also assess the borrower's current status (whether he is in bankruptcy, for example), and the local courts that will oversee any judicial procedure. Based on an analysis of all these factors, the special servicer will choose a strategy that maximizes the liquidation proceeds. The strategy might include judicial foreclosure, negotiated payoff, or loan restructure.

Overall, while workout strategies are determined based on each asset's particular set of circumstances, the business plan that is ultimately developed to forecast resolutions, proceeds received, and timing to receipt, must balance the strategy that achieves a satisfactory resolution in the shortest period possible. The workout plans must constantly be monitored and examined and amended if circumstances surrounding the debtor and loan or property change. Monthly performance must be reviewed against targets established in the plans to track timing in particular.

While liquidation plans vary by property, early foreclosure action is generally pursued for small assets to gain immediate leverage over the obligor, while the treatment of larger assets is more on a case-by-case basis, depending on the situation.

The actual process of a judicial foreclosure is relatively straightforward. The court first obtains a third party appraisal of the collateral property (CTU), which establishes the initial court-sanctioned auction price, or reserve price. On obtaining the CTU, the court will set the date for the first public auction of the asset, generally at least six months hence.

If there is no buyer willing to purchase the asset at the reserve price, the court reschedules a second auction sale (usually between two and 12 months later, depending on the court and its workload). The reserve price for the next auction is automatically reduced by 20% from the previous CTU. This process continues until a buyer finally comes forward.

If a full judicial foreclosure process is envisioned, the special servicer must accurately project a schedule detailing the steps necessary to achieve resolution and closing of each asset, the anticipated costs to reach resolution, and a summary of key events anticipated for each year. The plans will cover such items as expected legal fees, environmental issues, zoning and planning issues, appraisal fees, and other court procedure expenses.

To maximize sale proceeds and minimize the time to resolution, the special servicer will generally pursue an out-of-court settlement directly with the borrower, while simultaneously pursuing legal process toward foreclosure and rent attachment, as a back-stop strategy and useful leverage against borrowers.

A DPO or out-of-court settlement is a resolution of a given delinquent loan through a negotiation with the borrower resulting in a discounted settlement of the total outstanding loan balance on an all-cash or short-term repayment basis.

Notifying borrowers that management of their delinquent loans has been transferred to a special servicer who has immediately accelerated the obligations alerts the debtor that its obligation will now be treated in a different manner. By proactively managing the debtor and the delinquent situation, the resolution process is often accelerated. Borrowers are often looking to settle their debts and now have a proactive servicer with whom they can negotiate. This is particularly true in cases where the borrower is either living in the property (i.e., a residential unit) or is using the premises for his on-going business purposes. Negotiating a discounted pay-off with a borrower is frequently the quickest possible resolution and is carried out to the extent it is more favorable than a judicial resolution.

The resolution price at which a DPO is finally negotiated is often subject to predetermined target prices by the special servicer and the owner of the portfolio of loans. Target prices represent the minimum cash out-of-court settlement acceptable based on numerous factors. A series of target prices are calculated for each loan corresponding to each successive year of the forecast and makes up an integral part of the final business plan.

KGI Corso Venezia and SIB are together the special servicer for Island Finance. The joint venture has been rated by Standard & Poor’s Servicers Evaluation group as “above average.” A separate report publicly available contains the full analysis of the entity and may be consulted in examining the assessment of the Island Finance transaction.

The joint venture was formed in 1997 between KGI Corso Venezia, a Morgan Stanley Dean Witter subsidiary, and SIB. SIB was formed in 1986 by a consortium of 10 Italian banks for the express purpose of negotiating loan workouts, and leasing and selling foreclosed properties, and has real estate professionals, six-person in-house legal counsel, and a network of over 520 brokers and sales agents it contracts with throughout Italy. The company is the only firm in Italy with 14 years experience in Italian loan workouts/own real estate (ORE) asset management. As a result of its expertise and experience, both Banca Morgan Stanley and Morgan Stanley real estate funds (MSREF) have purchased ownership interests in SIB (their combined interest is 25.9%).

Through its network of 500 real estate agents throughout Italy, SIB instead locates buyers during the period of litigation and foreclosure and brings them to the judicial auction to purchase the property or the note. This might be considered a tenuous strategy except for the lengthy foreclosure process in Italy (on average seven years). Given the amount of time before foreclosure auctions occur (and reoccur if there is no buyer for the asset at the court sanctioned reserve price), SIB has demonstrated success at locating end purchasers.

As part the transaction’s corporate overview, SIB’s management team in Sicily has been interviewed and its experience and expertise in the field has been researched and tested. SIB’s historical track record in dealing with non-performing loans, forced sales, and foreclosures represents a main strength of this transaction.

***Servicer Compensation and Incentives***

Compensation of the servicer is an integral component of a successful liquidating structure. Appropriate incentive to liquidate the loans in a timely manner for the maximum amount of net proceeds realizable is essential. Asset managers are incentivized through compensation structures that reward rapid dispositions at prices that equal or exceed predetermined target prices for each asset. These compensation structures were reviewed and assessed and found to satisfactorily provide a high level of incentive to appropriately motivate the asset managers.

SIB receives a fixed percentage fee of the cash recovered. Additionally, SIB and KGI Corso Venezia receive an incentive fee which is based on the excess of collections relative to the basic collections agreed in the business plan. This incentive fee is applied to all collections and the incentive fee increases as actual collections exceed business plan collections. The incentive fee is subject to a profitability test to ensure assets are liquidated profitably.

The analysis on the business plan cash flows were stressed and are and found not to be scenarios where the servicer could outperform the business plan cash flows.

### Portfolio Details

The portfolio securitized by Island Finance (ICR4) S.p.A. consists of two subportfolios. A portfolio of mortgage claims secured on real estate (mortgage portfolio) and a portfolio of claims from borrowers which are part of the mortgage portfolio (connected portfolio). The mortgage portfolio accounts for approximately 86% of the total GBV and for approximately 97% of projected cash flows. The connected portfolio accounts for approximately 14% of the total GBV and for only 3% of the projected cash flows (see Table 1).

**Table 1**

**Portfolio Overview**

| Subportfolio | Number of loans | GBV (Mil. Eur) | Percentage projected cash flow (%) |
|---|---|---|---|
| Mortgage | 2,553 | 1,190 | 97 |
| Connected | 937 | 188 | 3 |
| Total | 3,490 | 1,378* | 100 |

*GBV as at March 31, 1999. As at Dec. 31 1999 aggregate GBV was Eur1,429 million

The analysis was centered on the mortgage portfolio as it is the main source of repayment. The projection methodology for the connected portfolio is consistent with the requested ratings.

The mortgage portfolio consists primarily of mortgage loans secured on properties located predominantly in Sicily (88% by GBV), 6.1% by GBV located in Rome, and the remainder spread in other major Italian cities. The mortgage loans are primarily first mortgage liens (83% by GBV) or second mortgages (14% by GBV); in the latter case these are almost exclusively of borrowers which are also in the pool with a first mortgage. SIB has projected considerably lower recovery rates for loans backed by a second mortgage.

There is a diverse mix of properties by use. Approximately 45% of the portfolio consists of residential properties (“residential” plus mixed residential/retail), followed by industrial properties (13%), retail (12%), hotels (8%), land (6%), and agricultural (4%). The mixture of the portfolio is consistent with the small business nature of the regional economy.

As mentioned before, the legal status of proceedings is comparatively not advanced since the average date of default is 1993 and, on approximately 22% of the mortgage portfolio by GBV, the servicer needs to initiate proceedings. However, the projection of each mortgage asset’s recovery timing has taken into account the status of the legal proceedings and resulted in a longer time to recovery than for previous transactions.

There is a satisfactory distribution by obligor sizes, with the largest obligor not exceeding 2% of the portfolio by GBV.

### Credit and Cash Flow Analysis

#### *Net Realizable Proceeds*

A cash flow model was developed which projected recoverable proceeds within certain time frames on an asset by asset basis using the business plans. The net realizable proceeds forecast to be recovered is the critical element in the analysis and evaluation.

The cash flow model limits amounts recoverable from any loan by one of four factors:

- The SIB market valuation of the asset;
- The outstanding loan balance plus accrued interest; and
- The recorded mortgage amount (Ipoteca), or the court sponsored appraisal (CTU), if available.

If the outstanding loan obligation was less than the SIB value, or recorded mortgage amount or the court's reserve price/value, then the model would project recoverable proceeds equal to the outstanding obligation. The asset model defaults to the lowest of these figures as the maximum realizable, before netting out court and other ancillary costs. For information purposes, 60% of the portfolio is capped by SIB value, 21% by outstanding balance, 16% by CTU, and 3% by Ipoteca.

#### *Valuation Sensitivities*

SIB real estate collateral valuation are the values determined by SIB during the initial corporate overview and underwriting of the portfolio in the period April 1999 to November 1999. The SIB valuations were performed by the local representatives who are actively working in the different markets throughout Italy. In every case, SIB took a discount to the free market valuation of between 15% and 25% to reflect the fact that the real estate would be sold at foreclosure auction. A further average discount of 20% was taken if the property was occupied by either the debtor or a tenant to reflect the desires of the vast majority of potential buyers to occupy the purchased premises. In addition, market comparables, potential purchaser opinions, local market, and specific property characteristics were all considered. The valuations derived by the local professionals were then reviewed by SIB's regional and headquarter management as well by KGI Corso Venezia for accuracy and reasonableness.

In addition to the SIB valuations, a sample of the properties visited and others were appraised by Gabetti S.p.A, an Italian real estate firm. The Gabetti valuations were on average 66% higher than SIB valuations. Furthermore, for a sample of approximately 500 properties, SIB verified its valuations against the initial valuations given by the seller at the time the mortgage loans were granted. These were found to be approximately 100% higher than SIB valuations.

The lower SIB distressed liquidation valuations were relied on for the purpose of analyzing the cash flows. The distressed liquidation collateral valuations of an experienced servicer were only taken into account.

If the CTU value is the factor determining net realizable proceeds the model may adjust this value. The CTU value is decreased between auctions should the previous auction be deserted (no bidders). This is done in order to make the real estate collateral more attractive to potential buyers through lowering the reserve price at which it can be purchased. The standard in courts throughout Italy and that written in the foreclosure law is that the sale price should be lowered 20% for each successive auction. Though it may be argued in court by either debtor or creditor to have adjustments other than 20%, the courts respect this unbiased mathematical procedure.

Court fees, the costs incurred by the creditor to proceed through the foreclosure or bankruptcy process, are factored into the model. These expenditures include payment for the accumulation of the recorded documents from the municipal records office, the preparation of the CTU, and the advertising required prior to a foreclosure auction, as well as payment of delinquent real estate taxes, if any, to the court tribunal for court services. All of these expenditures can be recouped should the real estate collateral sell at a sufficient price for the creditor to receive repayment.

SIB has developed an elaborate foreclosure/bankruptcy expense forecasting model from which the court fees have been estimated. These periodic expenses have been modeled as a percentage of gross collateral sales proceeds to facilitate forecasting flexibility in the model simulation. Should the collateral sale be sufficient to repay the creditor for these court process expenditures, the forecasting model does so at the point that the court distributes the final creditor proceeds (defines as the T3 period), not as a reduction of modeled periodic expenses.

#### *Timing Sensitivities*

The model is also very sensitive to timing forecasts for the resolution of the assets. Delays in resolution timing has a detrimental effect on the transaction's economics. Several aspects of the model can be adjusted to reflect delays to the resolutions forecast in the business plans. The business plans' timings were based on historical experience and actual figures of what the Italian banks have been able to achieve.

Factors that effect timing of resolutions include:

- Timing to obtain a CTU;
- Timing from obtaining a CTU to first auction;
- Timing between auctions;
- Total auction disposition timing;
- Total auction disposition timing;
- Timing of cash flow between T1 and T2;
- Foreclosure cash flow timing between T2 and T3;
- Maximum number of auctions; and
- Timing characteristics of individual court tribunals.

In the absence of a CTU, the procedure to obtain one will not be finalized until a court acceptance is received. (CTUs have not yet been obtained for approximately 85% of the loans in the Island Mortgage portfolio).

The model foresees the CTU value equaling 125% of the SIB valuation when it is finally obtained. The effect in the model is to project that the asset will be sold at the second auction, when the reserve price has been automatically reduced by 20% from the first auction, and the resultant price is now within 5% of SIB's market value.

#### *Discounted Pay-Offs (DPOs)*

The effect of forecasting DPOs is to reduce the resolution timing for the deal.
Based on the historical success in negotiating DPOs, the model allows for forecasting the number of loans that are resolved through DPOs. For Island Finance it is projected that 30% of the portfolio subject foreclosure proceedings (none in the case of insolvency proceedings) will be resolved via DPO so that slightly less than 20% of the projected cash flows would arise from DPOs. This is a conservative fraction of the servicer's experience. Forecast resolution proceeds from DPOs can also be viewed as a percentage of the target price.

The target price represents the business plan expected proceeds valued on a net present value basis. Consequently, the target price increases over time.

#### *Collection Details*

Banco di Sicilia will provide the issuer with an interim collection account into which debtors can make payments. Banco di Sicilia is not rated by Standard & Poor's. However, amounts standing to the credit of the interim collection account will be transferred out of the interim collection account at the earlier of every 15 days or when the balance reaches Eur500,000 (this represents only less than 0.125% of the amount of rated notes at issue). The rest of the issuer accounts will be with Deutsche Bank AG

***Stress Analysis***

No credit was given to the untested timing benefits of the Notary Law, the availability of Gabetti and seller valuations, the availability of historical recovery experience of the seller, the possibility of accruing and recovering interest at the higher loan contractual rate (rather than at the current legal rate of 2.5%), or the possibility of any assignment of property asset rentals or spontaneous payment made by borrowers.

The business plan cash flows were initially stressed and no scenarios where the servicer outperforms the business plan cash flows emerged. The stress scenarios are created in the special context of the servicer's track record and are not applicable to other servicers.

'AAA' Scenario

- Increase SIB/CTU by 25%;
- Reduce the servicer's business plan DPO assumption by 17% and spread the DPOs over a 25% longer time frame, with a decline of DPO execution prices by between 5% and 20% over the DPO time frame;
- Worsening of SIB's timing by 15%; and
- SIB liquidation values down a further cumulative 20% over five years.

'AA' Scenario

- Increase SIB/CTU by 25%; and
- Reduce the servicer's business plan DPO assumption by 17% and spread the DPOs over a 25% longer time frame, with a decline of DPO execution prices by between 5% and 20% over the DPO time frame.

'A' Scenario

- Increase SIB/CTU by 25%;
- Reduce the servicer's business plan DPO assumption by 17% and spread the DPOs over a 25% longer time frame, with no decline of DPO execution prices; and
- SIB liquidation values down a further cumulative 7% over five years.

'BBB' Scenario

- Increase SIB/CTU by 25%; and
- Reduce the servicer's business plan DPO assumption by 17% and spread the DPOs over a 25% longer time frame, with no decline of DPO execution prices

## Hedging Strategies

***Interest Rate Risk***

Projected recoveries are assumed to be fixed from an interest rate sensitivity perspective. The issuance of floating-rate notes is, therefore, hedged by an interest rate cap.
The cap provider is Deustche Bank AG whose long-term senior unsecured debt obligations are rated 'AA' and whose short-term senior unsecured rating is 'A-1+'.

The cap provides that, should six-month EURIBOR exceed 5.75% per year, the cap provider pays the issuer a difference based on the notional amount of the cap.

The notional amount of the cap has been calculated by selecting, for each note payment date, the higher of:

- The class A notes under the 'AAA' scenario;
- The sum of the class A and B notes under the 'AA' scenario;
- The sum of the class A, B, and C notes under the 'A' scenario; and
- The sum of the class A, B, C, and D notes under the 'BBB' scenario.

The cap ensures that the issuer is hedged against adverse movements in interest rates in a manner consistent with the more conservative scenario appropriate for each class of notes.

***Liquidity Risk***

The timing of recoveries is primarily dependent on the timing of judicial resolutions and secondarily on the timing of DPOs. Unlike in performing assets, there is no scheduled payment for NPL assets and it is the task of the special servicer to achieve a sufficient level of recoveries.

The liquidity risk is mitigated by a liquidity line which will ensure payment of interest on the investment grade notes.

The liquidity line has been initially sized to be Eur42.7 million and will be equal, on every payment date, to 11.25% of the bonds outstanding on the previous payment date.

The liquidity line amount covers approximately 2.8, 2.1, 1.9, and 1.7 years of interest expense at the 'AAA,' 'AA', 'A', and 'BBB' levels (each level including the interest of tranches rated higher), with interest calculated at the cap rate plus the relevant margin.

It was noted during the stress analysis that use of the liquidity line was always of a very limited nature evidencing ample liquidity support.

## Legal Structure

The Island Finance transaction will be executed in accordance with Italian law 130 of April 30, 1999 (the Securitization Law). The issuer of the bonds is a special-purpose Italian limited liability company incorporated under the law 130. The issuer bought a portfolio of non-performing loans from the seller (Banco di Sicilia S.p.A.) as documented by a transfer agreement dated Dec. 30, 1999, as amended on or before the issue date. The notes will be constituted by a trust deed.

The review of the legal documents and opinions is being undertaken and these preliminary ratings are subject to the satisfactory completion of this review.