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Servicer Evaluation

Credito Fondiario e Industriale SpA (Fonspa) (Primary Servicer Of Commercial And Residential Mortgages In The Italian Market, Italy)

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Opinion

The ranking on Credito Fondiario e Industriale SpA (Fonspa), a wholly owned subsidiary of Morgan Stanley Real Estate Funds (MSREF), is affirmed as "ABOVE AVERAGE" as a primary servicer of commercial and residential mortgages in the Italian market.

The "ABOVE AVERAGE" ranking reflects the following:

- The executive team demonstrates a high degree of industry knowledge and proficiency with regard to the servicing of residential and commercial loans. On average, each executive has in excess of 20 years' experience in the Italian mortgage market.
- The company maintains documented procedures for all core functions. It operates with a well-designed technology environment that provides the necessary levels of process automation and internal control.
- Fonspa's organizational structure contains proper segregation of duties, smooth workflow, and operational efficiencies in relevant centralized functions.
- As an added resource, Fonspa is able to leverage across the banking group of companies to achieve operational efficiencies, such as with executive duties and a shared internal audit function.

Outlook: stable

Since our last review, Fonspa has continued to implement the program of change undertaken in the previous years, with a return to the core business lines of primary servicing and mortgage lending. Fonspa has restructured its servicing business and launched a lending platform to provide residential prime and non-prime mortgage loans, and credit support to Italian nonperforming loans (NPL) securitizations finalized by MSREF. While maintaining the focus on servicing, Fonspa entered into two distribution agreements with PRE Franchising and Banca Mediolanum, and plans to generate €1 billion of prime and subprime mortgage loans in the next two years.

Fonspa expects a small profit in 2005 and improved profitability as the residential origination platform grows; 2007 should be the first stabilized year in that respect.

We believe there are sufficient controls in place to continue orderly servicing operations. However, management priorities need to be tested over the coming year to ensure expansion will not jeopardize servicing standards and procedures.

Company Profile

Fonspa was a publicly traded mortgage bank based in Rome, which was purchased by MSREF through a majority shareholder negotiated purchase, followed by a public tender offer in October 2000. Fonspa is an integral part of Morgan Stanley's real estate operation in Italy. The Fonspa group comprises key companies as outlined below.

Fonspa

Fonspa is the mortgage servicer and lender of prime and subprime loans. It is responsible for corporate servicing, group company relationships, and group data compliance to the Bank of Italy.

MSP Corso Venezia S.r.l. (MSPCV) / Servizi Immobiliaria Banche SpA (SIB) (now Credit Servicing (CS))

This is the special servicer of NPLs and a strategic vehicle for the acquisition of NPLs.

SIB and the former Pirelli Real Estate Credit Servicing SpA merged to create Credit Servicing (CS), which is 52% owned by Fonspa.

International Credit Recovery (5) S.r.l., International Credit Recovery (6) S.r.l., International Credit Recovery (123) S.r.l., International Credit Recovery (8) S.r.l., and Promozioni e Assistenza Immobiliari SpA

This is a group of NPL and real estate-owned vehicles in which Fonspa has equity ownership.

As of June 30, 2005, Fonspa employed 152 full-time employees. Altogether, there are 37 staff dedicated to mortgage servicing activities, 36 dedicated to new lending, approximately 70 dedicated to activities that cover both areas, and six staff dedicated to the banking group's activities. The company operates from a central office in Rome.

The portfolio under management totaled approximately 37,000 loans and €4.7 billion, as of June 30, 2005, compared to 55,000 loans and €4.1 billion in 2003. The old legacy of NPL portfolios has been replaced by more structured transactions with larger loans; hence the marked decrease in loan numbers despite a 12% increase in total volume.

Fonspa Portfolio

Table 1 shows the Fonspa portfolio as of June 30, 2005.

Table 1: Fonspa Portfolio							
	June 2005	December 2004	December 2003	December 2002*	December 2001	December 2000	December 1999
Total amount (Mil.€)							
Total	4,759	4,794	4,144	4,869	3,711	1,952	4,994
Residential mortgages	3,511	3,493	3,886	4,549	2,141	800	2,283
Commercial mortgages	620	621	0	0	1,010	499	1,717
Industrial	426	453	4	5	141	181	340
Public works	202	227	254	315	419	472	654
Total number of loans							
Total	36,792	38,344	55,023	64,576	61,694	54,549	106,468
Residential mortgages	33,168	34,849	54,687	64,167	56,839	50,865	99,765
Commercial mortgages	3,290	3,141	0	0	4,396	3,172	6,089
Industrial	132	143	86	106	135	134	152
Public works	202	211	250	303	324	378	462
*Excluding International Credit Recovery (6) S.r.l.							

As of June 30, 2005, Fonspa services 15 transactions in various capacities and also acts as special servicer in three performing loan transactions (see table 2).

Table 2: Details Of Transactions Under Administration As Of June 30, 2005					
Operation	Originator	Portfolio	Number of loans	Gross book value (Mil. €)	Fonspa's role
Colombo S.r.l.	Fonspa	Performing loans to Italian public entities	145	189.3	Master-special servicer
Diocleziano	Fonspa	Performing mortgage loans and public work loans	4332	309.5	Master servicer
Augusto 1	Fonspa	Performing mortgage loans	4739	71.3	Master servicer
Augusto 2	Fonspa	Performing mortgage loans	1820	32.5	Master servicer
SPV Columbus	Italfondiaro	Performing mortgage loans	704	8.5	Master servicer, corporate servicer, and calculation agent
Berica MBS S.r.l.	Banca Popolare di Vicenza Scrl	Residential performing mortgage loans	3,433	127.7	Calculation agent and representative of noteholders
Berica MBS2 S.r.l.	Banca Popolare di Vicenza Scrl	Residential performing mortgage loans	3,225	192.2	Calculation agent and representative of noteholders
International Credit Recovery (1) S.r.l.	Sanpaolo IMI SpA	Nonperforming mortgage loans	1,231	132.1	Master servicer, corporate servicer, account bank, and paying agent
International Credit Recovery (2) S.r.l.	Sanpaolo IMI SpA	Nonperforming mortgage loans	968	131.2	Master servicer, corporate servicer, account bank and paying agent
International Credit Recovery (3) S.r.l.	Cassa di Risparmio in Bologna SpA	Nonperforming mortgage loans	520	78.6	Master servicer, corporate servicer, account bank, and paying agent
International Credit Recovery (5) S.r.l.	Sanpaolo IMI SpA	Nonperforming mortgage loans	12,008	1,028.0	Master servicer
International Credit Recovery (6) S.r.l.	Fonspa	Nonperforming mortgage loans	13,339	1,469.0	Master servicer and Italian operating bank
International Credit Recovery (8) S.r.l.	BNL	Nonperforming loans	435	734.0	Master servicer
Imser Securitisation S.r.l.	Fonspa	Commercial performing mortgage loans	5	1,104.0	Facility agent, servicer, and issuer corporate servicer
Quarzo CL1	Morgan Stanley Bank	Commercial performing loan	1	350.0	Facility agent, servicer, and calculation agent
ELOC program	Morgan Stanley Bank	Commercial performing mortgage loans	4	205.5	Italian sub-servicer
Residential loans	Fonspa	Residential performing mortgage loans	169	22.6	Facility agent, servicer and issuer corporate servicer

Management And Organization

The ranking for management and organization of "ABOVE AVERAGE" is affirmed.

Fonspa continues to have a management team that can draw on the expertise of a general manager with a background in European banking, senior managers with lengthy careers at Fonspa, and a board of directors comprising key executives from Morgan Stanley's Italian and continental European operations. In addition, there is senior management expertise within the banking group, which can be called upon if required. There has been a very low turnover in senior management. Together, the senior management team has, on average, 27 years' industry experience and 23 years' experience in servicing MBS. Nearly three employees out of four have more than fifteen-year tenures with Fonspa.

Management is active and Fonspa was able to redefine bank objectives in a dynamic market environment and carry out a program of change to achieve rationalization and growth of two lines of business, namely master and primary servicing and residential lending. This was achieved under one corporate business plan. In doing so, the bank has rationalized its operations, strengthened procedures and processes, increased staff training, and clearly defined its goals. The introduction in the past year of a management accounting system at departmental level has been effective in improving resource allocation, services pricing, and budget compliance.

We consider that Fonspa's organizational structure enables it to actively service mortgage-backed transactions across Italy and provides for:

- Proper segregation of tasks from a control perspective;
- Independent internal audit, regulatory, and compliance control;
- Clear reporting lines for effective decision-making;
- Capacity to readily absorb and integrate portfolio growth in a controlled manner;
- Responsiveness to client needs; and
- Effective leverage of central functions within the banking group, e.g., the internal audit facility.

Staffing

Fonspa has provided significant investment in training, staff relationships, an appraisal system, and the monitoring of objectives. Overall, Fonspa's approach to staffing is considered to be good.

The human resource department, along with line managers, displays a solid and expanding commitment to ongoing and formalized training initiatives. The training program follows a matrix plan covering eight areas and five experience levels. Each area is ranked by importance for each department. Training for each staff member is tracked centrally to monitor goals. Fonspa's training platform encompasses a combination of in-house and outsourced training. Training requirements have increased approximately 10% in the past year, and staff now undertake an average of five days of continuing education annually.

Together with investment in training, Fonspa has a comprehensive objective-setting and performance monitoring program. In 2002, the company introduced a management-by-objective system (MBO) aimed at improving performance by sharing goals and objectives throughout the company. Targets are tracked and performance feedback is provided to all departments and the board on a quarterly basis.

In conjunction with the MBO system, the company has a well-formulated performance appraisal system based on set criteria. Both the MBO system and the performance appraisal results are used in establishing bonus incentive plans for staff.

The workforce remains stable with a low staff attrition rate of less than 2% a year to date. To encourage new ideas and creativity, Fonspa has embarked on a selective but active recruitment process. We expect that this initiative, as well as the grooming of existing junior staff, will strengthen the middle management ranks.

Technology

An IT steering committee, under the responsibility of mixed working groups including the internal audit department, defines strategic developments and operational priorities. With a fairly generous budget, it has been instrumental in implementing further quality control, system enhancements, and automation .

The IT systems are all fully integrated and provide for a central application, named K4F, to manage the entire loan process and administration, including the management of judicial and legal foreclosure procedures. K4F operates in an IBM CICS mainframe environment with system data being hosted by an industry standard database. The functionality of K4F is constantly monitored to ensure it is able to handle new portfolio acquisitions.

In addition to its main loan processing system, a number of applications, used in support of Fonspa's activities, have been integrated with K4F. They include:

- General ledger and accounting;
- Data warehouse and investor reporting;
- Banking transaction; and
- Regulatory reporting.

Since our last review, there have been two further applications integrated with K4F: credit scoring (EXPERIAN) and underwriting (PEM).

K4F operates on a data system with internal interfaces with the special servicer within the banking group and an interface for external special servicers. The interface provides for data transfer and reconciliation.

The Web site has been restructured and revamped, but it is not yet completed. Passwords to gain access to controlled areas for investors are in the process of being distributed to privileged parties. We expect the site to be fully operational by the next review. Achievement of this objective is essential to maintaining the "ABOVE AVERAGE" ranking.

All systems are properly protected and access-controlled. The company that manages the main computer center (Banksiel) is based in Bologna. Fonspa has a backup server site 50 kilometers from Rome where eight people can be immediately transferred. Disaster recovery plans are in place and have been tested. The last mainframe test in June 2005 and the last local server test in December 2005 detected no malfunction, and simulations operated adequately.

Procedures

Fonspa operates with fully documented policies and procedures covering all critical functions, and these are sufficient for the operating business. Servicing procedures are electronically available to staff through the intranet system and regularly updated by the Human Resources department.

Key features of the processes and procedures are:

- Appropriate control mechanisms are in place governing procedural changes.
- Operating procedures include a delegation-of-authority matrix to ensure that Fonspa sufficiently controls its decision-making and approval processes.
- Fully documented procedures are in place covering the pre-approval, underwriting, and completion of new lending transactions. However, the valuation and property inspection procedures could be more tightly monitored.
- An ALM committee was created in June 2004, chaired by the deputy general managers to review lending, accounting, and finance/treasury functions.

Control

MSPCV's independent audit team has overall control at the group level and coordinates the auditing activity within Fonspa. An annual risk-based audit program is devised across the group and reports on a quarterly basis to the board itself.

In addition, Fonspa's internal audit unit conducts annual ongoing compliance and control reviews of various operational processes in respect of Italian banking and corporate legislation, including compliance with Law 231 regarding criminal activities. We found no major issues arising from the latest audit report in September 2005.

We consider that the audit cycle program, with its different levels of control, is effective with regards to the servicing function.

Lawsuit and insurance coverage

Besides two civil litigations regarding former minority shareholders, Fonspa has no material outstanding lawsuits. The company has appropriate insurance for corporate liability, building, and fidelity coverage.

Loan Servicing

The rankings on Fonspa as a commercial mortgage servicer and as a residential mortgage servicer are affirmed as "ABOVE AVERAGE".

As of June 30, 2005, Fonspa directly serviced a total of 15 portfolio transactions, which comprised performing and nonperforming mortgage loans secured by residential and commercial properties. The servicing role is provided to Morgan Stanley group (Italy) and third parties.

The bank demonstrates good controls and procedures for handling investor reporting, regulatory reporting, loan boarding, and payment processing and reconciliation.

Loan setup and data integrity

The loan boarding process is well controlled and efficient and has been improved by enhancements to technology:

- A dedicated team of seven employees handles the new loan setup on the servicing system (K4F) based on input from subservicers (typically SIB) through electronic transfers.
- Due diligence is carried out to avoid data deficiency before loan boarding.
- Independent checks are performed by IT and the statutory reporting office before final handover of the management of new loans to K4F.
- Standard loan files are controlled through a central file room and sound file management procedures, including a file tracking system maintained on the bank's intranet.

The loan boarding team has the additional responsibility for calculating the total loans owed (TLO) for each of the loans because courts have differing requirements. As was the case last year, K4F is not able to fully carry out the TLO calculation, so this is processed on Excel sheets. Despite the shortcomings of this process, Fonspa succeeded in signing a service agreement with a third-party bank for the preparation of TLO calculations on that client's NPLs. Fonspa has the necessary controls in place to reduce error, but at a cost of reduced efficiency.

Payment processing and investor accounting

The payment processing and investor accounting process is described below.

- The corporate remote banking system (CORBAN) provides collection data, which is electronically transferred to K4F through a nightly batch program.
- Reconciliation between collections and issuer bank accounts is undertaken. Unmatched collections are held in an appropriate suspense account.
- A further reconciliation is undertaken with the special servicer to split collections between principal, interest, legal expenses, and costs.
- Through the proprietary software "Fluscont", the loan management office checks the accuracy of data processed on a daily basis. It also reconciles the gross book value of all the loans under administration on a monthly basis.
- The payment processing office sends to the special servicer, on a daily basis, lists of collections received on NPL portfolios. On the following day, the special servicer returns the files with information and the collections are posted to the loans in the system. The office solicits the special servicer for any unmatched collection every week. The payment process and reconciliation process are performed in the same office, but separately and by different people.

The process can be complex because of the nature of the payment received and the requirement to split any payments between costs and principal for each asset. This has led to an ongoing dialogue with the special servicer with regard to account allocation. This process can be timely and open to error. However, appropriate quality control procedures are in place.

In order to segregate reporting from remittance task, within the accounting and finance department, a separate invoices processing unit manages the remittance process.

Investor relations and reporting

The investor relations office handles compliance with servicing agreements, securitization offering circulars, and other reporting regulatory requirements. This five-person unit

reports on portfolio management, analysis and control of Law 130, and performs the duties of facility and security agent, and calculation agent. Reports are automatically produced through direct downloads from servicing system data. Detailed checklists for each transaction establish electronic action ticklers. Electronic exception reports are produced monthly and reported directly to the special servicer.

Fonspa is available online for its banks to review daily bank transaction activity, which facilitates the formal account reconciliation and monthly monitoring processes. Investor reporting procedures are fully documented.

Fonspa is also responsible for the regulatory reporting of the special servicer, SIB/CS.

Insurance tracking

Approximately 90% of Fonspa's borrowers obtain their property insurance coverage through a blanket policy from Fonspa. Their payment statements include the premium amounts, which are tracked within their loan records on the servicing system.

The other 10% of borrowers, which are often business and corporate loan customers, obtain and pay for their own insurance policies directly. Fonspa relies on receiving notification from the insurance carrier that these annual policy premiums have not been paid. If it receives this notification, Fonspa pays the premium and adds it to the payment due. The new lending procedures call for a one-time payment of the insurance premium at closing, covering the entire life of the loan.

Financial Position

Fonspa's financial position is considered "SUFFICIENT". The ranking for financial position is based on the long-term credit rating on Morgan Stanley (A+/Stable/A-1), the sponsor of MSREF, which owns Fonspa.

The continued investment in and success of its Italian servicing platform suggest that this is a strategic operation within the MSREF portfolio of companies.

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