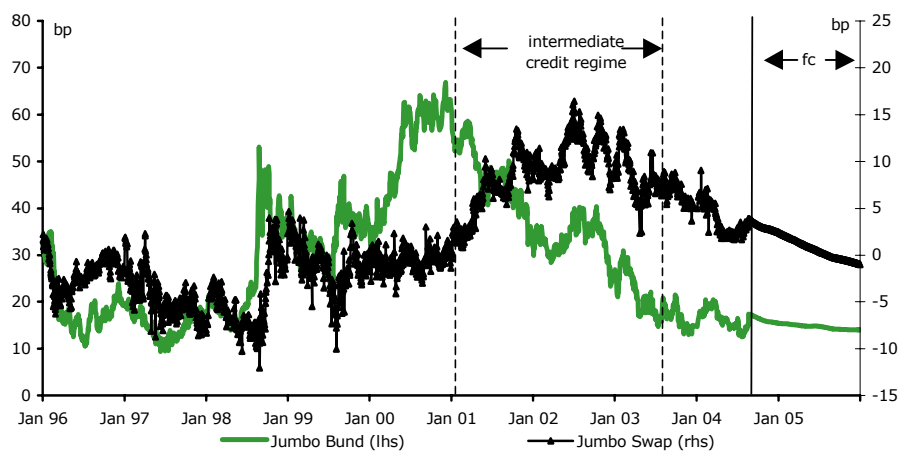


Cover Up - European Mortgage Bonds

Rates

The rally has not ended

Jumbo swap spreads should decline further and enter a new but well-known trading range. A continuous improvement of the credit and rating profile as well as a growing investor base are the main triggers to the process, supported by increasing liquidity, market diversification and stable Bund swap spreads.

 Europe
Covered Bonds
Chart 1 : 10y Jumbo Pfandbrief spreads


Source: ABN AMRO

Although covered bond swap spreads have declined almost continuously for one year, we believe the rally will continue. Current levels do not mark the lower end of the trading range observable before 2001, but should rather re-enter the trading range observable in the second half of the 1990s. In the future 10-year Jumbo swap spreads should trade in a range closely around and even below Euribor flat levels.

The main forces behind the spread contraction throughout the recent year have been an improving credit sentiment driven by legal amendments and improved ratings as well as the introduction and acceptance of fully structured and structurally enhanced covered bonds (CB).

A further rise in the share of triple-A rated CB in the secondary and primary markets, rising rating stability, a widening investor base and higher market diversification will help the market reach even lower swap spread levels.

Upcoming supply in CB this autumn could lead to an intermediate Jumbo swap spread widening. However, the long-term trend of tighter Jumbo swap spreads should remain intact, supported by stable Bund swap spreads and our forecast of an unchanged monetary regime by the ECB until the end of 2005.

Disclosures and analyst certifications are at the end of the body of this research.

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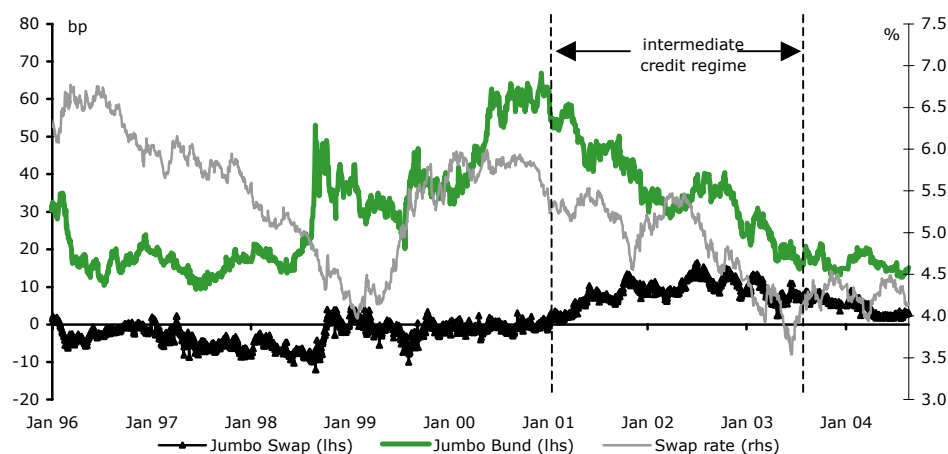
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More room for tighter spreads

For more than one year, the performance of covered bonds (CB) is a one-way street with continuous swap spread tightening. Since the beginning of 2003, swap spreads have declined an average 9-10bp across the entire curve. Ytd average spreads tightened 2-5bp with long-term maturities underperforming. Throughout the entire move, weaker credits notably outperformed stronger credits, partly by up to 10bp. Although compared with other credit markets, these moves look minor, they are large in the world of covered bonds and mark the difference required to make the business profitable. You feel like profit taking on your positions? We believe it is still too early and that there is more room for further Jumbo swap spread contraction.

Chart 2 : 10-year Jumbo Pfandbrief spreads and swap rates



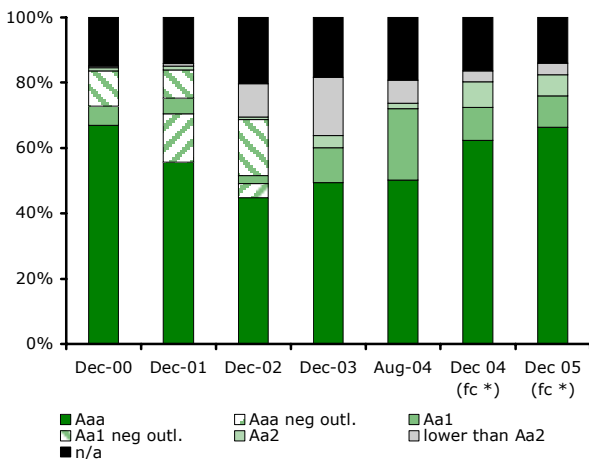
Source: ABN AMRO

To better understand this forecast we need to recall a couple of aspects driving covered bond spreads in the past. Until the end of 2000, in the 9-10 year area of the curve, covered bond spreads predominately traded in a swap spread range of -5bp to 0bp (see chart 2). While yield levels had no particular influence on spreads, benchmark spread did. On the back of the Asian crisis in 1997 and the Russian crisis in 1998, widening Bund swap spreads fuelled wider Jumbo swap spreads. Investors closed their covered bond positions, which underperformed versus benchmarks. Nevertheless, the most important factor for the stable and low swap spread environment of CB at that time was the solid credit basis of the issuing banks, in particular, the excellent rating of CB with more than 85% of them being triple-A rated by S&P and 70% by Moody's.

In December 2000, when 93% of the outstanding Jumbo CB were German Pfandbriefe, the situation changed significantly. The following three years witnessed a remarkable credit deterioration in the German banking sector. At that time, many mortgage banks were subsidiaries of larger commercial banks. Thus their rating was linked to that of the parent company. On the back of Moody's rating methodology of linking the Pfandbriefe rating to the unsecured rating of the issuer, the rating quality of the Pfandbriefe deteriorated in line with downgrades of banks' unsecured ratings. The crisis reached its peak in 1Q03 when only 45% of all outstanding Jumbo covered bonds were left with stable 'Aaa' ratings (see charts 3 and 4). The notable issuance of 'Aaa' rated paper in other Jumbo covered bond market segments did not really manage to soften this move. Throughout this period, S&P ratings did not face any

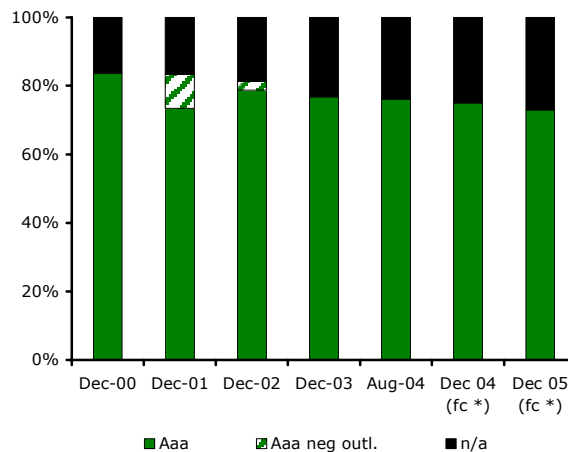
changes since these ratings are de-linked from that of the issuer. However, investors' guideline to follow the weaker one of split ratings and thus in case of Jumbo CB mostly Moody's ratings, caused significant widening in Jumbo swap spreads. Between January 2001 and July 2002 the Jumbo Pfandbriefe swap spread in the 9-10 year area widened by not less than 14.5bp. At the short end of the curve, spreads also increased during this period, though slightly delayed. Here, the peak was reached towards the end of 2002.

Chart 3 : Moody's rating structure of outstanding Jumbo CB



Source: ABN AMRO

Chart 4 : S&P's rating structure of outstanding Jumbo CB



Source: ABN AMRO

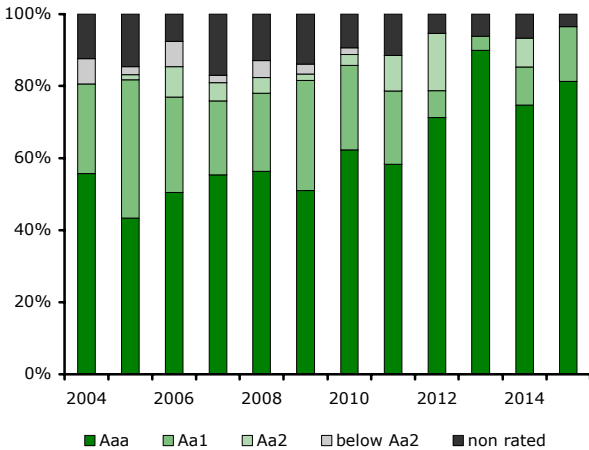
Since the peak of the crisis in 2H02, Jumbo covered bond swap spreads continuously declined. The main driving forces behind this included the amendments of legal frameworks in various countries, in particular, Germany. All these amendments were predominately aimed at achieving an improved position for covered bondholders and their preferential claim on the collateral assets, a higher bankruptcy remoteness of the bonds and more precise asset-liability management guidelines. This was acknowledged by rating agencies, which provided more room for de-coupling covered bond ratings from that of their issuer. Most importantly, Moody's widened its notching for German Mortgage Pfandbriefe from three to four notches and for Public Pfandbriefe from four to five notches. In addition, Moody's introduced a floor rating concept for German Pfandbriefe ('Aa1' for Public Pfandbriefe and 'Aa2' for Mortgage Pfandbriefe). This has already improved the rating composition of the entire Jumbo covered bond market (see chart above). Secondly, the introduction and acceptance of fully structured CB and enhanced structured CB using securitisation techniques has provided more room for issuers to directly influence, ie enhance, their covered bond ratings. Thirdly, almost all issuers that had their inaugural transactions within the past couple of years issued 'Aaa/AAA' rated CB. This is likely to cause the ratio of 'Aaa' rated Jumbo covered bond gross supply to reach c72% this year compared with only 57% in 2003. Finally, where a country witnessed and supported the introduction of a CB market, investors based in that country also became increasingly positive about CB. In all cases, at least during the first two years after the first inaugural deal was launched in the respective country, investors' demand out of 'new' countries to exceed the supply offered out of the same countries.

However, the improvement times have not ended yet and we identified the following aspects as supportive for Jumbo CB in the months ahead:

- 'Aaa' rated Jumbos are expected to count for 75% of the supply of gross Jumbo CB in 2005. This level would underline the re-establishment of a credit landscape in the Jumbo world, as seen before 2001.
- The ratio of 'Aaa' rated Jumbo CB outstanding should increase further, reaching a ratio of 66-68% by the end of next year. The ratio of Jumbos rated below 'Aa2'

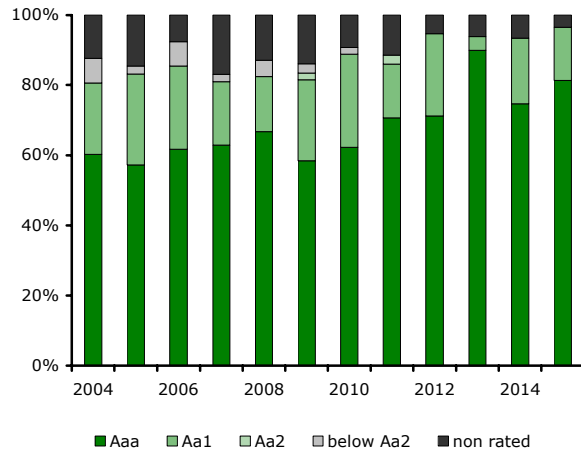
should have declined towards 4% by the same time. This move will not only be driven by redemption flows and gross supply, but also by three further upgrades we expect in the German market for the remainder of this year. We expect Moody's to upgrade the Public Pfandbrief of HYPESS from 'Aa1' to 'Aaa', the Mortgage Pfandbriefe of HVB from 'Aa3' to 'Aa2' and the Public Pfandbriefe of HVB from 'Aa2' to 'Aa1'. In particular this will cause the rating composition in medium- and short-term maturities to improve (see charts below).

Chart 5 : Moody's rating structure of outstanding Jumbo CB by maturity (end August 2004)



Source: ABN AMRO forecasts

Chart 6 : Moody's rating structure of outstanding Jumbo CB by maturity (end December 2004F)



Source: ABN AMRO forecasts

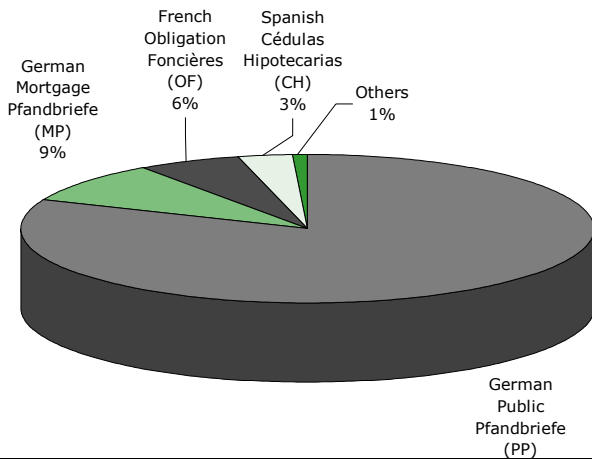
- As already experienced in 1995-2000, Jumbos will in the future be characterised by a very high degree of rating stability, which is expected to exceed the level seen in the 1990s. The main driving force are the legal amendments and the high quality standard of those legal frameworks enacted in this decade. In particular the intention to reach a better degree of bankruptcy remoteness and the rising focus on detailed, legally fixed post-bankruptcy procedures are of key relevance. This is supported by the fact that the rating agencies do not only consider the respective legal frameworks but also give credit for contractual regulations established by individual issuers.
- Additional Western European countries will join the covered bond market in the months and years ahead, with Italy being next this autumn. Even in some non-European countries, the issuance of Jumbo CB collateralised with mortgages might be witnessed next year.

This move should provide a sufficient basis to rally further and for spreads to contract further. We do not believe that CB markets, ie Jumbo swap spreads, are trading at the lower end of the spread range observable in the recent four years. In contrast we expect the market to finally leave the spread regime dominated by credit concerns. Swap spreads are likely to re-enter the phase already known from the second half of the 1990s with 10-year Jumbo swap spreads trading in a range closely around Euribor flat. Spreads in the 2-year and 5-year are likely to fully trade at sub-Euribor levels, partly even down to Euribor -10bp levels. Hence, we believe current spreads are marking the upper end of the new trading regime. We are not concerned about the most recent widening in longer-term maturities. This was almost exclusively based on intermediate profit taking and window dressing ahead of the new issue wave expected in autumn this year. While the upcoming supply in CB this autumn could lead to further selective intermediate Jumbo swap spread widening, we expect the general long-term tightening trend to remain intact. In fact the supply driven Jumbo swap spread widening could lead to attractive entry opportunities.

The risk of a set-back in Jumbo swap spreads is limited. Besides the more solid and stable rating environment, we noticed a couple of other effects that are supportive and clearly limit the risk of a spread widening observable in recent years.

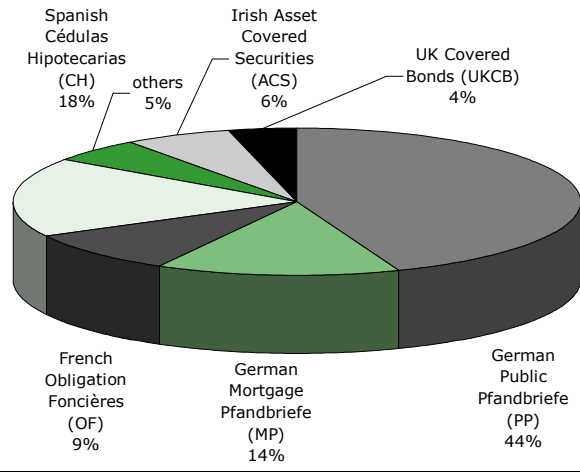
- The Jumbo market is far more diversified than five or eight years ago. At the end of 2005 we expect the share of the two largest market segments, Public Pfandbriefe and Spanish Cédulas Hipotecarias, to count for a market share of only 44% and 18%, respectively. At the end of 2001, the two largest market segments, Public and Mortgage Pfandbriefe counted for 81% and 9% of the market respectively (see charts below). Thus the credit deterioration in a single market segment, driven by domestic aspects or operational activities, should have less effect on the entire market as in previous days.

Chart 7 : Composition of outstanding Jumbo CB market (end 2001)



Source: ABN AMRO

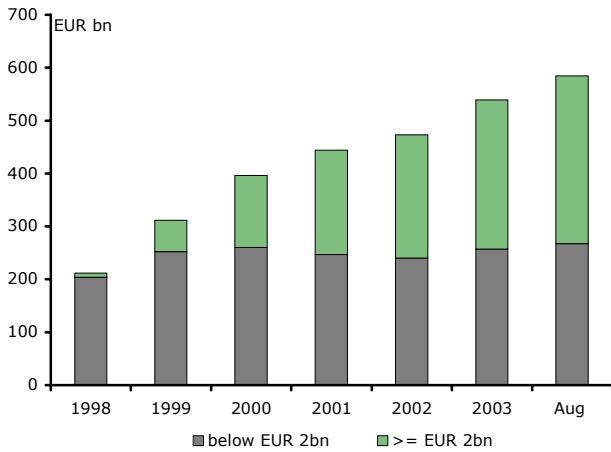
Chart 8 : Composition of outstanding Jumbo CB market (end 2005F)



Source: ABN AMRO forecasts

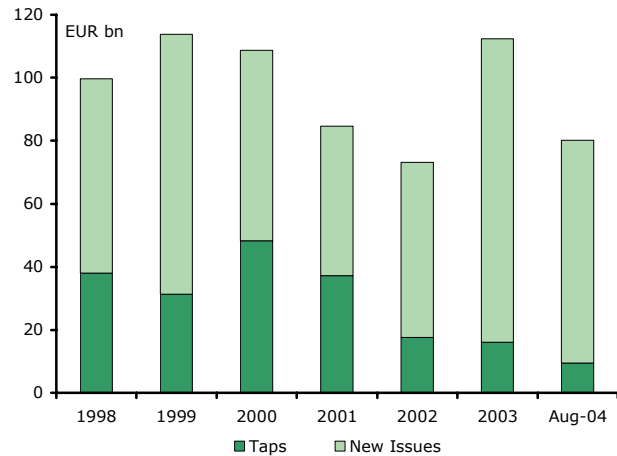
- Liquidity in Jumbo covered bonds increased in recent years. At the end of 2004, the average outstanding volume of Jumbos is expected to be €1.7bn compared with €1.25bn at end-2000. During this period the importance of electronic trading platforms and thus the degree of market transparency increased. At the end of 2000 only 35% (€137bn) of Jumbos counted for an individual volume of €2bn or more. At the end of August 2004, this ratio reached a level of c55% (€317bn). €2bn is the current threshold for Jumbos to become eligible on EuroCredit MTS, the most important B2B electronic trading platform. At the same time, tapping activities have become significantly less important. In the future we believe the total amount and share of gross funding activities run via taps to remain at current low levels, ie counting for only 10% of the entire yearly gross supply of Jumbo CB. This will also help liquidity to improve since it can be observed that bonds issued with a large volume already at first launch provide a notably higher degree of liquidity than those reaching an equivalent outstanding volume via several taps.

Chart 9 : Composition of outstanding Jumbo BC by volume classes



Source: ABN AMRO

Chart 10 : Composition of yearly Jumbo CB gross supply



Source: ABN AMRO

- Bund swap spreads are unlikely to widen in the months ahead. Therefore, Jumbo benchmark spreads should not face upward pressure. This forecast is based on our expectation of the ECB running a stable monetary regime until the end of 2005, no notable decline in public deficits in the euro area and a widening of ECB tier-one eligible assets by May 2005.
- A stable monetary regime by the ECB will continue to support carry driven trades. Historical evidence shows that this is particularly supportive for 2-4 year maturities and thus fuel a bullish steepening of the credit curve.

The only major risk to our Jumbo swap spread call we can identify is the limited spread differentiation currently to be observed within the market. The spread differentiation between rating classes has reached historical lows. Jumbos rated 'Aa1' are only trading at a swap spread c1.5bp above those rated 'Aaa'. Structural aspects such as optional soft bullet maturities have no significant impact on prices. This could change in two cases. First, significantly more fully structured bonds with different characteristics and unused structural elements will join the market. This is likely, but will happen gradually with the impact on spreads slowly working. Second, a serious setback in housing prices and thus rising default and delinquency ratios will be seen in particular countries, eg Spain or the UK. Although housing prices in various European countries have reached very high levels, such a dramatic turn is currently not on the cards.

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