



# Derivative Fitch

## CDO *pinions*

A global biweekly credit derivatives and CDO update

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### CREDIT TRENDS AND NEWS

#### CDS Spreads Change Course

Credit default swap (CDS) spreads have reversed course from the pattern of ever tightening spread levels experienced throughout 2006 and into early 2007 on significantly higher than average volume, according to a recently released Derivative Fitch CDS Roundup. Spreads widened substantially since February 27th as a confluence of negative events hit the credit markets, including falling global equity prices led by China, and subprime mortgage and ABX concerns. For example, spreads of the CDX Investment Grade Series 7 index tightened from four basis points (bps) to 31 bps from the beginning of the year to Feb. 27th, but by mid-March had given up these gains, widening five bps, on much higher than average volume. The study found that the average U.S.-dollar denominated CDS spread tightened by approximately ten bps through Feb. 27th but by mid-March had given up an average of seven bps due to the recent market turmoil.

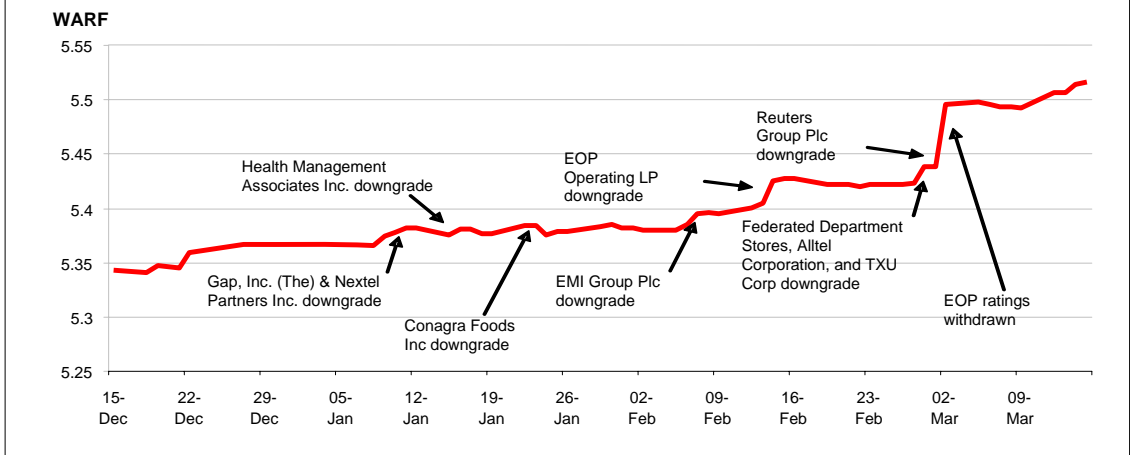
The spreads in the automotive sector continued to tighten until February this year, but also abruptly reversed course. Additionally, on a percentage basis, sectors such as homebuilding/building materials, insurance, banking and finance, have exhibited weakness, with their average spreads widening 20%, 14% and 13%, respectively, as of March 15th. Worries over subprime credit exposure have contributed to widening spreads among entities in the banking and finance sector, such as Washington Mutual and Countrywide Financial. Similar to the U.S., Euro-denominated CDS spreads exhibited significant tightening during 2006, but as of mid-March spread performance has been more mixed. Finally, the breadth of entities referenced in the CDS market continues to expand, as evidenced by the growing number of entities referenced on a weekly basis.

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Synthetic Index (15 Dec '06 to 15 Mar '07)



SOURCE: Derivative Fitch

### **Synthetic Index Continues to Reflect Deterioration**

Derivative Fitch's synthetic index, a proprietary tool that monitors the performance of static synthetic CDOs referencing corporate entities, shows continued deterioration in corporate credit quality during the quarter which began on the 15th of December 2006 to the 15th March '07. The weighted average rating factor (WARF) of the index, which is a measure of credit quality, has deteriorated by 3.24% during this period. The period from February 15th to March 15 this year was the most volatile in the quarter, showing a 1.63% WARF deterioration. Although these numbers may be slightly inflated due to the high volume of mergers & acquisition (M&A) activity that is causing ratings on entities such as EOP Operating LP to be withdrawn, and hence treated as 'CCC' by the index, there is still substantial evidence to show that the actual credit quality is also declining.

Although there were more upgrades than downgrades during this quarter with a ratio of 1.07 upgrades for every downgrade, and the magnitude of upgrades was also larger with a positive net notch movement of 117 compared to a negative net notch movement of 108, the WARF has deteriorated due to the downgrades representing a larger proportion of the index. Downgrades were 6.78% of the index compared to upgrades which were 5.02% of the index. This trend can be seen with the one notch downgrade of the second most widely referenced name in the index, Federated Department Stores, which represents 0.5%. Furthermore, the U.S., which represents more than half of the index, experienced the largest negative net notch movement of nine with heavy downgrades across industries including health care & pharmaceuticals (Health Management Associates' five notch downgrade – 0.07% of index), telecommunications (Alltel Corporation's one notch downgrade – 0.30% of index), and food, beverage & tobacco (ConAgra Foods Inc.'s one notch downgrade – 0.11% of index). More details on the index's methodology and the latest index report are available at [www.derivativefitch.com](http://www.derivativefitch.com).

### **Defaults Hit German Mezz SME CLOs**

Two German small-and medium-sized enterprises (SMEs) filed for insolvency in January and March this year. Both companies were referenced in the collateral pools of mezzanine SME CLOs in the form of profit participation agreements (PPAs), which are deeply subordinated loans combining features of both debt and equity. Due to the higher single obligor concentrations in these transactions, a default has a greater impact compared with traditional SME CLOs. These new insolvency proceedings followed the filings of two other companies which were part of the mezzanine SME CLOs that were issued in 2004 and in '05. The occurrence of these defaults, which are so early in the lives of their respective transactions, has surprised some market participants and has led to a discussion about the risks involved in this transaction type.

These particular SME CLOs include a feature known as a Principal Deficiency Ledger (PDL), which is debited by an amount equivalent to the defaulted balance, and the most senior notes starts to amortize using excess spread from the portfolio in line with the pay down of the PDL balance. Therefore, losses can be absorbed over time. However, if a clustering of defaults occurs, excess spread collections may not be sufficient to fully repay the PDL balance leading to a loss on the rated notes.

The first insolvency filing of this year, of a German auto supplier, occurred on the 22<sup>nd</sup> of January and affected FORCE 2005-1 Limited Partnership (Force) with 2.7% and StaGe Mezzanine Societe en Commandite Simple's (StaGe Mezzanine) with 5.7% exposures. The second default, a German shoemaker, followed on the 13<sup>th</sup> of March, affecting Preps 2004-2 Limited Partnership (Preps 2004-2) with 2.4% and Preps 2005-2 Plc with 2.8% exposures. While this represented the first credit event in Preps 2005-2 and StaGe Mezzanine transactions, Preps 2004-2 and Force have each suffered from a previous credit event in mid-2006 when the German toymaker, Nici AG, filed for insolvency. However the PDL had already absorbed the impact of this event. Fitch reviewed the performance of all the exposed transactions, following the initiation of insolvency proceedings and assigned a negative rating watch to StaGe Mezzanine, while the three other transactions had enough structural protection for their

ratings to be affirmed. The rating watch was the result of two separate events - the insolvency proceedings and a payment 'holiday' granted by StaGe Mezzanine to another portfolio entity in September 2006 until July 2008. Fitch continues to closely monitor the performance of this sector.

## Dissecting Mortgage Credit Drivers of the ABX-HE

Troubles in the U.S. housing market have put the ABX-HE indices in the spotlight. The indices, which comprise of baskets of credit default swaps, allow market participants to express a credit view on benchmark sets of subprime residential mortgages. In its latest research report, Mortgage Credit Drivers of the ABX-HE, Fitch's residential mortgage group recently analyzed the underlying collateral of the reference obligations for the three ABX-HE indices (ABX-HE-06-1, 06-2 and 07-1). According to the study, the weighted average collateral attributes are very similar. However, there is a slight drift in credit quality between the 06-1 series and the 06-2 and 07-1 series as shown by the rise in debt-to-income ratios and the decline in Fair Isaac Corp. (FICO) scores. The three indices have similar concentrations of piggyback second lien loans, which are taken by the borrower to finance the mortgage's down payment, and limited documentation loans. Although the risk factors of the 06-1 index are similar to those of the other two indices, the performance profile tells a different story. Delinquencies for the 06-2 and 07-1 reference entities are substantially higher compared with those for 06-1, the study found.

The high delinquency rates of the deals underlying the ABX indices are concentrated among those loans with limited documentation of borrower income, combined with very high leverage in the form of piggyback second lien loans. The relatively high delinquencies of the 06-2 and 07-1 indices versus the 06-1 are highly correlated with the degree of home price appreciation (HPA) experienced by the properties in the various indices, with low-or-no HPA exacerbating the delinquency trend for the 06-2 and 07-1 indices. In contrast, the mortgages underlying the 06-1 index experienced significantly more HPA during the early months following origination.

If delinquencies and losses continue their relatively high trajectory, 2006 vintage loss rates could exceed those of prior poor performing vintages, perhaps reaching the 6%-8% range. While Fitch does not rate all of the deals referenced by the ABX Index, losses in this range could put ratings downgrade pressure on the reference entities for the 06-2 and 07-1 BBB- indices. To read the full results of the special report please go to [http://www.fitchresearch.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=319362](http://www.fitchresearch.com/creditdesk/reports/report_frame.cfm?rpt_id=319362).

## VALUSPREAD

This table illustrates the two-week movement of the Dow Jones CDX & iTraxx Europe indices.

Index Name	2007-03-16 Mean*	2007-03-30 Mean*	Percentage Change
iTRAXX Europe - 125 Series 6 (ex 12/2011)	24.9075	22.685	-9.79722
iTRAXX Europe - Crossover Price Index Series 6 (ex 12/2011)	223.2	202	-10.495
iTRAXX Europe - Senior Financials Price Index Series 6 (ex 12/2011)	9.5625	7.5625	-26.4463
iTRAXX Europe - Sub-Financials Price Index Series 6 (ex 12/2011)	17.5	14	-25
iTRAXX Europe - HiVol Price Index Series 6 (ex 12/2011)	47.7188	41.4075	-15.2418

\*Data is calculated by Derivative Fitch based on actual contributions received from market participants. For more data analysis contact the Valuspread team at [www.valuspread.com](http://www.valuspread.com).

## **COLLATERAL TALK**

### **SUBPRIME SNAPSHOT**

It's rare opening any newspaper or trade publication these days without the subprime mortgage worries in the headlines. Fitch Ratings and Derivative Fitch analysts have been closely monitoring and measuring the impact of this problem in different market sectors including structured finance (SF) and trust preferred (TRUPS) CDOs, residential mortgage-backed securities (RMBS) and other forms of structured vehicles such as asset-backed commercial paper (ABCP), and among financial guarantors. Additionally, Fitch's U.S. RMBS and CDO teams jointly hosted a webcast late last month and spoke on the subprime mortgage market's impact on the ratings performance of RMBS and CDO transactions. A replay of the webcast, which drew more than 600 participants, can be accessed at <http://www.visualwebcaster.com/event.asp?id=38583>. Fitch has endeavored to publish timely pieces to address investors' pressing concerns. The following commentaries below summarize the agency's views and draws upon the deep knowledge of its various analytical teams.

#### **Moderate Rating Actions Projected for Mezz SF CDOs**

Subprime RMBS downgrades will likely translate to moderate, one to two notch, negative rating migration for 2003-06 mezzanine U.S. SF CDOs. Fitch recently examined a sample set of mezz SF CDOs from the 2003-06 vintage that it had previously rated, and re-rated them using varying stress levels. Fitch believes that it is too early to predict the performance of specific RMBS bonds, and subsequently any CDOs holding those bonds. The future performance of subprime RMBS and the mezzanine SF CDOs that own them depends upon many factors. The structure of mezz SF CDOs, collateral asset manager ability, subprime RMBS servicer strength and market conditions may either help mitigate or increase the impact of any deterioration in mortgage loan performance on mezz SF CDOs, according to the study. The CDO structure and initial credit enhancement levels will contribute to the different results in the downgrade severity across CDOs. For instance, two deals with similar credit portfolios, but different structures can experience varying ratings volatility. The tranches of a more conservatively structured CDO can weather any stress better than the tranches of a more aggressively structured transaction, even if the former has a riskier underlying portfolio.

More than 220 Fitch-rated high grade and mezz SF CDOs have exposure to U.S. subprime RMBS bonds to date. U.S. SF CDOs have an average exposure of 44.7% while European SF CDOs have 22.7%. One hundred thirty-seven Fitch-rated SF CDOs currently have exposure to mezz subprime RMBS, 95 of which were issued in 2003 or after. The average exposure to subprime RMBS for 2003- 06 vintage CDOs ranges from 43.3% to 71.3%. Seven of the 10 most common servicers in mezzanine SF CDOs are rated a high 'S1' score as of March 2007, as primary servicers for subprime loans. Servicing strength is a key factor in loss mitigation. Approximately 3.2% of 2003- 06 vintage mezz SF CDO portfolios are comprised of below investment grade (IG) subprime RMBS, and 16% 'BBB-' assets. These RMBS assets are most at risk for default or downgrade due to their position in the capital structure. To view the full results of the study, please go to [www.derivativefitch.com](http://www.derivativefitch.com).

#### **U.S. TruPS CDOs May Feel Slight Impact**

CDOs of trust preferred securities (TruPS CDOs) may also be feeling a slight pinch from the problems in the subprime mortgage space. The majority of TruPS CDOs have been historically collateralized by preferred securities issued by banks and insurance companies. But the more recent transactions are backed by TruPS and unsecured subordinated debt issued by real estate investment trusts (REITs), real estate operating companies and financial institutions specializing in real estate lending.

Fitch currently rates 18 CDOs collateralized, at least partly, by residential mortgage REITs or other residential mortgage lenders. Eleven of the 18 CDOs are characterized as REIT TruPS CDOs that are backed by residential mortgage REITs, and commercial mortgage REITs, equity REITs, homebuilders

and commercial mortgage-backed securities (CMBS). The remaining seven Fitch-rated CDOs are classified as hybrid TruPS CDOs because they are backed by blended portfolios of TruPS and bank and insurance company-issued subordinated debt and REITs. In a study, Fitch found that exposure to subprime residential mortgage lenders is concentrated among three CDOs with a total exposure of approximately USD 134 million. On a positive note, exposure to subprime residential mortgage lenders represents only 8.4% of total prime and subprime residential mortgage lender exposure within REIT and hybrid TruPS CDOs. In addition, Fitch has observed that exposure to residential mortgage lenders as a percent of total collateral underlying REIT TruPS CDOs has declined since 2005. This could be attributed to the lower coupons on the securities that are issued by residential mortgage lenders, reducing the potential arbitrage opportunities between assets and liabilities of the CDO.

Fitch has not seen any defaults or deferrals with respect to any collateral underlying REIT TruPS CDOs to date. However, recent developments in the subprime residential mortgage REIT space have materially increased the likelihood of one or more defaults or deferrals. This has led Fitch's REIT group to downgrade and/or place on Negative Watch the shadow issuer default ratings (IDRs) of several subprime mortgage REITs. The agency believes this has the potential to negatively impact CDO liability ratings of one REIT TruPS CDO in the near future should further credit deterioration occur. To read the full report entitled Residential Mortgage Exposure in CDOs of Trust Preferred Securities, please go to [http://www.fitchresearch.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=318790](http://www.fitchresearch.com/creditdesk/reports/report_frame.cfm?rpt_id=318790).

### **Financial Guarantors Hold Steady**

Financial guarantors or bond insurers appear to be relatively well-positioned to withstand the stresses placed on residential mortgage securitizations in the event of financial strains experienced by less stable RMBS originators and servicers. In the past few years, financial guarantors have maintained a large and increasing exposure to prime and subprime RMBS. The ongoing subprime woes have raised investors' concerns on the degree of exposure and potential impact on the financial guaranty industry.

Fitch recently looked into financial guarantors' exposure to less stable RMBS originators/servicers. The study found that financial guarantors' insured net par exposure to securitizations totaled almost USD 24 billion. While this aggregate figure appears substantial in nominal terms, the majority of the exposure is to the most highly rated classes within individual securitizations. Specifically, more than 70% of the aggregate exposure is rated in the 'AAA' or 'AA' categories. The highly rated senior classes of RMBS securitizations are structured to have substantial credit enhancement available to absorb stress case losses from a securitization's collateral pool. While financial guarantors have so far shown steadiness amidst the uncertain subprime mortgage market, Fitch does not rule out individual instances of problems involving securitizations of less stable RMBS originator/servicers. However, these problems are likely to be isolated and small in relation to each financial guarantor's capital base and level of earnings.

The full report entitled Subprime Worries? Financial Guarantors Exposure to Weaker RMBS Originator/Servicers can be accessed at [http://www.fitchresearch.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=318348](http://www.fitchresearch.com/creditdesk/reports/report_frame.cfm?rpt_id=318348).

### **U.S. ABCP Exposure Stays at Manageable Levels**

U.S. asset-backed commercial paper (ABCP) investors remain well insulated from the pressures facing other market participants with exposures to subprime mortgages. Fitch's U.S. ABCP analytical team found subprime exposure in 24 partially-supported Fitch-rated ABCP programs representing a cross-section of multi-seller, securities-backed and single-seller conduits. These programs had direct exposure to facilities or securities backed by subprime mortgages originated by 25 different subprime originators. Additionally, subprime-related mortgage exposure decreased sharply during the fourth quarter of 2006 from a significant spike in the prior year. Fitch's study shows that subprime exposure comprised 3.3% (USD 7.6 billion) of its U.S.-rated ABCP (non-fully supported) outstandings as of Q406. The figure is down more than 30% from its Q405 peak of approximately USD 11 billion. However, while subprime

exposure is declining, it remains more than three times above 2004's average of USD 2.2 billion, which reflects the strong growth in the sector in the last two years.

## **INNOVATIONS**

### **Derivative Fitch Launches VECTOR 3.1**

Derivative Fitch recently introduced its latest version of its proprietary Default VECTOR model, the rating agency's main quantitative tool for evaluating default risks in credit portfolios backing CDOs. VECTOR 3.1 includes a CDO comparator, which enables users to quantify the impact of portfolio substitutions on the Rating Loss Rate (RLR), Default Rate (DR) and Recovery Rate (RR) of the initial portfolio. In addition, a more sophisticated matching engine has been added to the VECTOR Reference Entity Feed (REF) to facilitate better communication between the Fitch feed and end users' proprietary feeds. Both VECTOR 3.1 and the Reference Entity Feed can be downloaded at [www.derivativefitch.com](http://www.derivativefitch.com).

### **VECTOR SME CDO Model Makes Debut**

Fitch's new methodology and model for rating CDOs of European small-and-medium sized enterprise (SME) loans made its debut last week. The Fitch Default VECTOR SME model (VECTOR SME) is based on a similar theoretical framework as VECTOR 3.1, the agency's core quantitative tool for analyzing most corporate and structured finance CDOs. VECTOR SME is a multi-factor model that takes into account default probabilities or ratings, recovery rate assumptions and correlations to produce default and loss distributions using Monte Carlo simulation. For example, the analyses of Spanish SME CDO portfolios, which are among the most active markets in this sector, will utilize a simulation approach for the first time. The correlation framework applied in VECTOR SME is in line with the Basel II framework for small-to-medium sized companies.

The European SME CDO Rating Criteria can be accessed via [http://www.fitchresearch.com/creditedesk/reports/report\\_frame?rpt\\_id=320064&criteria=Y](http://www.fitchresearch.com/creditedesk/reports/report_frame?rpt_id=320064&criteria=Y).

## FITCHCDX.COM – GLOBAL INDUSTRY SECTOR PRICE MOVEMENTS\*

This table illustrates the two-week movement of the Dow Jones CDX & iTraxx Europe indices.

Fitch Industry	Week of 30-Mar-2007	Week of 23-Mar-2007	Spread Change	% Change 📉	# Assets
Healthcare & Pharmaceutical	86	82	4	5.0 %	3
Retail	88	85	3	4.1 %	10
Miscellaneous	105	103	3	2.8 %	59
Computers & Electronics	83	81	2	2.7 %	17
Food, Beverage & Tobacco	47	46	1	2.3 %	19
Leisure & Entertainment	144	142	3	2.0 %	3
Paper & Forest Products	96	95	1	1.5 %	10
Textiles & Furniture	98	97	1	1.4 %	5
Transportation	78	77	1	1.3 %	17
Automotive	150	148	2	1.2 %	23
Consumer Products	57	56	1	1.2 %	10
Telecommunication	83	82	1	1.2 %	24
Utilities	57	56	0	0.4 %	30
Gaming, Lodging & Restaurant	97	97	(1)	(0.6) %	5
Industrial / Manufacturing	96	96	(1)	(0.8) %	10
Broadcasting & Media	125	127	(1)	(1.2) %	20
Aerospace & Defense	13	14	0	(1.8) %	4
Chemical	105	107	(2)	(1.9) %	18
Building & Materials	50	51	(1)	(2.2) %	15
Banking & Finance	32	33	(1)	(2.3) %	150
Energy	60	62	(2)	(3.2) %	4
Supermarkets & Drug Stores	85	89	(4)	(4.4) %	10
Sovereign	130	137	(7)	(5.2) %	15
Metals & Mining	65	69	(4)	(5.3) %	8
Insurance	11	12	(1)	(7.9) %	21

\*Weekly credit default prices sourced from GFI Group Inc. ([www.GFIgroup.com](http://www.GFIgroup.com)). Visit [www.fitchcdx.com](http://www.fitchcdx.com) for advanced analysis and data for the credit derivatives market.

## FITCH-RATED CDOs – AS OF FEBRUARY 2007

This is a list of the variety of deals Fitch has rated in the U.S., Europe and Asia. The agency has also rated several private transactions during this period.

### USA

Deal Name	Deal Type
Attentus CDO III, Ltd.	Trust Preferred CDO
Babson Quantitative Mortgage CDO	Market Value CDO
Camber Master Trust Series 7 & 8	Synthetic
CoLTS 2007-1	Middle Market CLO
Guggenheim Structured Real Estate Funding 2006-4	Commercial Real Estate CDO
Crystal River Resecuritization 2006-1	Commercial Real Estate CDO
Lexington Capital Funding III	Cashflow ABS CDO
Maxim HG CDO II	Cashflow ABS CDO
Nautilus RMBS CDO IV	Synthetic
Northstar Real Estate CDO IX	Commercial Real Estate CDO
Visage CDO II	Synthetic ABS CDO
Westways Funding X Ltd.	Market Value CDO

## EUROPE

Deal Name	Deal Type
Deal Name	Deal Type
Aeolus CDO Limited Colonnade II	Cashflow ABS
Aphex Capital Plc Series 31-33 SENWAI	Synthetic/CDO <sup>2</sup>
IM Cedulas, 10 FTA	SME CDO
HEAT Mezzanine S.A. Compartment 3	SME CDO
Magnolia Finance V Plc Series 2007-6	Synthetic/Leveraged Super Senior
Smile Securitisation Company 2007 B.V.	SME CDO
SCUTE I B.V.	High Yield Loan CDO
Taberna Europe CDO I	Cashflow ABS
Zoo HF 3 plc	Alternative Investments/Hedge Fund

## ASIA

Deal Name	Deal Type
Beryl Finance Limited 2007-1	Synthetic
Corsair (Jersey) Limited Series 304	Synthetic
Morgan Stanley ACES SPC Series 2007-5	Synthetic
Morgan Stanley ACES SPC Series 2007-3	Synthetic
Morgan Stanley ACES SPC Series 2007-4	Synthetic
Zenesis Series 2007-2	Synthetic/ CDO <sup>2</sup>
Zenesis Series 2007-1	Synthetic/CDO <sup>2</sup>

**MARK YOUR CALENDAR****April 18****Derivative Fitch's Annual Global Credit Derivatives Conference**The Pierre  
New York, NY

This one-day event will feature Derivative Fitch's most seasoned analytical team discussing the latest structural and performance trends in the credit derivatives and CDO market. The annual confab will also highlight the rating agency's latest research.

**April 19 & 20****Derivative Fitch's Synthetic CDO Workshop**Hyatt Regency  
Greenwich, CTFitch Ratings Office  
Chicago, IL

Fitch's credit derivatives experts will travel to Connecticut and Chicago for a workshop that will address issues such as tranche pricing and valuation, correlations, market/credit risk and market dynamics affecting the synthetic CDO market.

For more information on these U.S. events, please contact Melissa Pompilii at 212-908-0357 or e-mail her at [melissa.pompilii@fitchratings.com](mailto:melissa.pompilii@fitchratings.com) in New York.

**April 24 & 25****Derivative Fitch's Annual Global Structured Credit Conference**One Great George Street  
Westminster, London

This two-day event will feature more than a dozen CDO managers, leading investors and Derivative Fitch's most seasoned analytical team discussing the latest structural and performance trends in the credit derivatives and CDO market.

If you are interested in attending this London event, please register online at [www.fitchratings.com](http://www.fitchratings.com) by clicking on the event link on the right hand side of the web page. You can also get more information or request a registration form by contacting Fitch's Events Team at [ecpm@fitchratings.com](mailto:ecpm@fitchratings.com) or at +44 20 7862 4051.

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