

Global Criteria Change for U.S. Structured Finance CDOs Reflects Heightened Subprime Risks

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Summary

Fitch has revised its methodology for rating structured finance collateralized debt obligations (SF CDOs) to reflect the increased risk associated with subprime residential mortgage-backed securities (RMBS) as portfolio collateral. The accelerated pace and magnitude of rating downgrades, especially in recent transactions, represent a significant departure from historical patterns of rating behavior. Loss expectations in the subprime sector have risen markedly due to slowing home price appreciation, anticipated rate resets, and the impact of risk layering on borrowers. On July 12, 2007, Fitch issued a press release announcing its revised rating methodology modeling assumptions, which increases the default probability for U.S. subprime bonds issued since 2005 by 25%.

This report reiterates this revision and further identifies additional criteria changes:

- o Increased default probability for U.S. subprime RMBS bonds issued since 2005 by 25%.
- o Modified methodology for treatment of U.S. subprime RMBS bonds on Rating Watch Negative to assume a minimum three subcategory downward rating adjustment for purposes of the rating definition used in Fitch's Default VECTOR model (VECTOR).
- o Fitch will take into consideration, in conjunction with input from Fitch's RMBS ratings group, the following additional factors that may further increase the 25% default probability adjustment or otherwise modify modeling assumptions when assessing the risks in SF CDO portfolios:
 - Recently issued subprime RMBS that are not seasoned enough to determine if worse than expected credit performance will manifest.
 - Closed-end second lien (CES) RMBS and prospects for recovery.
 - Anticipating if Alt-A RMBS will perform more in line with prime or subprime collateral.
 - Other SF CDOs and overlap by vintage and sector.
 - Transactions designated Under Analysis by Fitch.
 - Servicer and originator quality and diversification.

The methodology changes described herein are effective immediately. It should be noted that rating decisions are not purely model driven, and the ultimate decision rests on a credit committee that will qualitatively consider all factors, including CDO collateral, structure, and manager actions.

Assumed Default Probabilities for Subprime RMBS

Fitch's core CDO modeling tool is the VECTOR model. VECTOR is a ratings-based default model, whereby the expectation of default for an asset is tied to its rating. The default tables in VECTOR are based on historical ratings performance data that goes back over 20 years through several credit cycles. Subprime RMBS, particularly those issued since 2005, are experiencing high levels of delinquencies and defaults that are far above the expectations extrapolated from historical data. On July 12, 2007, Fitch revised its SF CDO rating methodology to increase the

VECTOR ratings-based default probability by 25% for U.S. subprime RMBS bonds issued since 2005. This modification was implemented to reflect the higher delinquencies and losses being realized in these recently issued vintages of subprime RMBS and may be further increased, depending on the actual transaction characteristics. The default probability multiplier is applied against the then-current subprime bond rating in VECTOR, regardless of whether the bond has experienced a recent rating change.

Treatment of Assets on Rating Watch Negative

The rating of an asset is the primary input into the VECTOR model for determining default probability. In the case of structured finance assets not rated by Fitch, the lowest publicly available rating from any nationally recognized statistical rating organization (NRSRO) is used. For assets on Rating Watch Negative, or similar indicator by other NRSROs, the VECTOR model assumes one subcategory downgrade for modeling purposes.

Given the extremely volatile performance of the subprime sector, recent rating actions have been more severe than historical data would suggest. As a result, Fitch is revising the one subcategory downward adjustment for all U.S. subprime RMBS tranches on Rating Watch Negative, or the equivalent indicator from other NRSROs, that are entered into VECTOR. Regardless of vintage, the downward adjustment is modified from one subcategory to three subcategories. However, as with the default probability adjustment, this adjustment may be increased, depending on transaction and collateral characteristics.

Additional Considerations

Fitch's SMARTView product monitors collateral performance in structured finance bonds, providing greater insight to Fitch's internal analytic screening process and furthers transparency by publicly identifying the transactions (the entire capital structure) that Fitch has identified as requiring an immediate review.

Fitch receives monthly information on structured finance transactions from trustees and servicers. Fitch RMBS analysts run this data through various internal algorithms to identify transactions as possible candidates for upgrade or downgrade. The analysts scrutinize the output to decide which transactions need a formal review. All tranches of these identified transactions are noted as Under Analysis. Analysts conduct a formal review to determine if rating action is appropriate on any of the classes. Generally, those reviews take place within 30 days. Although the entire transaction is placed Under Analysis, rating actions will typically not affect all tranches. As a final step, transactions will be given a SMARTView date, indicating the current nature of the ratings (for more information on SMARTView, see the criteria report dated May 3, 2007, available on Fitch's web site at www.fitchratings.com).

The significant number of transactions currently designated as Under Analysis and the expectation that many more transactions will become so designated in the near and intermediate term indicate that substantial rating migration may persist in the subprime RMBS market in the immediate future. When a CDO holds a tranche of a Fitch rated subprime RMBS transaction that is designated as Under Analysis, Fitch will consider all information available on the particular bond, including pool composition, servicer quality, and other lower public ratings to determine the rating input for the VECTOR model.

As the performance attributes of recent vintage subprime RMBS continue to be observed, certain high-risk attributes can be identified. These attributes include high concentrations of recent vintage second lien loans, especially CES RMBS bonds, which have demonstrated an extremely high-risk profile. Fitch may make adjustments if a particular Alt-A transaction is expected to perform similarly to a subprime transaction. Exposure to SF CDOs within a CDO may warrant closer inspection to determine vintage and sector overlap, which would magnify potential losses.

Especially in these areas, but also more broadly in consultation with Fitch's RMBS group, Fitch CDO rating committees will consider adjustments to the model. Such adjustments will include consideration of all available information on the particular bonds, regardless of whether it is Under Analysis, including pool composition, servicer quality, and other lower public ratings.

Notwithstanding the following examples, it should be noted that rating decisions are not purely model driven, and the ultimate decision rests on a credit committee that will qualitatively consider all factors, including CDO collateral, structure, and manager actions.

Impact of Modeling Changes

These revisions will have varying degrees of impact on SF CDOs, depending on a number of factors. These changes apply to both new and existing CDOs. The ultimate impact on Fitch's ratings may differ depending on the transaction type.

For pre-existing CDOs, Fitch will take into consideration the impact of seasoning, the amount of collateral rating migration supported by the deal, and the role of structural enhancements, such as OC and IC tests and excess spread, to determine appropriate rating action. For new transactions, these changes may lead to lower levels of leverage.

Portfolios concentrated in subprime RMBS issued since 2005 will have default probabilities higher than comparable portfolios with similar ratings that are more seasoned. Portfolios with assets on Rating Watch Negative will also have higher default probabilities based on the change to a three subcategory downward adjustment.

Impact of Changes on a Mezzanine Transaction

(%)

Tranche Rating	RDR Before Methodology Changes	RDR After Methodology Changes	Absolute Increase	Relative Increase
'AAA'	13.5	18.9	5.5	40.7
'AA'	12.0	17.2	5.2	43.1
'A'	8.5	13.1	4.6	54.5
'BBB'	3.9	7.0	3.1	79.7

Key Transaction Attributes

WARF Before Methodology Changes:	3.6
WARF After Methodology Changes:	5.2
Portfolio Weighted Average Life (Years):	5.25
Exposure to 2005–2007 Vintage Subprime (%):	80.0

Ratings Distribution Before Methodology Changes

Fitch Rating	Rating Concentration (%)
AAA	4.79
AA+	4.64
AA	10.30
AA-	1.44
A+	9.54
A	13.10
A-	8.02
BBB+	9.31
BBB	14.35
BBB-	18.88
BB+	3.03
BB	2.60

Ratings Distribution After Methodology Changes*

Fitch Rating	Rating Concentration (%)
AAA	4.79
AA+	2.28
AA	11.23
AA-	1.42
A+	8.49
A	11.16
A-	8.35
BBB+	9.69
BBB	11.40
BBB-	15.68
BB+	3.02
BB	3.71
BB-	5.31
B+	2.83
B	0.64

*Ratings distribution reflects impact of downward ratings adjustments to 10% of the portfolio on Rating Watch Negative.
Source: Fitch.

Impact of Changes on a High-Grade Transaction

(%)

Tranche Rating	RDR Before Methodology Changes	RDR After Methodology Changes	Absolute Increase	Relative Increase
'AAA'	3.97	5.31	1.34	33.8
'AA'	3.45	4.35	0.90	26.1
'A'	2.26	3.13	0.67	27.2
'BBB'	1.22	1.53	0.31	25.4

Key Transaction Attributes

WARF Before Methodology Changes:	1.5
WARF After Methodology Changes:	1.7
Portfolio Weighted Average Life (Years):	5.0
Exposure to 2005–2007 Vintage Subprime (%):	80.0

Ratings Distribution Before Methodology Changes

Fitch Rating	Rating Concentration (%)
AAA	16.80
AA+	3.82
AA	27.23
AA–	15.70
A+	18.09
A and Below	18.36

Ratings Distribution After Methodology Changes*

Fitch Rating	Rating Concentration (%)
AAA	15.92
AA+	4.41
AA	22.59
AA–	6.36
A+	20.57
A and Below	30.14

*Ratings distribution reflects impact of downward ratings adjustments to 10% of the portfolio on Rating Watch Negative.
Source: Fitch.

Assuming a hypothetical mezzanine transaction with a weighted average rating factor (WARF) 'BBB+/BBB', 80% of the portfolio consists of U.S. subprime RMBS, all of which is 2005–2007 vintage, and 10% of the assets on Rating Watch Negative, the impact of these changes, as measured by the rating default rate (RDR) at different stress levels, is illustrated in the table on page 3. The impact on RDRs for a high-grade transaction (WARF 'AA–/A+'), assuming 80% of the portfolio consists of 2005–2007 subprime and 10% exposure to Rating Watch Negative, is illustrated in the table above. These examples demonstrate that both mezzanine and high-grade CDO transactions are sensitive to these modeling changes, with mezzanine CDOs relatively more sensitive.

Implementation of Methodology Changes

The VECTOR model provides users sufficient flexibility to manually incorporate these revisions until an updated version that accounts for these changes is publicly available. To implement the 25% increase to defaults for the affected assets, the user can enter 125% in the default probability multiplier column of VECTOR for that asset. To implement the three subcategory downgrade adjustment for the affected asset classes, the user should manually enter the rating after taking into account the effect the adjustment. As VECTOR currently makes a one subcategory adjustment for assets on Rating Watch, the user needs to remove the Rating Watch indicator to prevent double counting. However, for assets outside subprime RMBS that are on Rating Watch, the normal one subcategory adjustment would still apply and the Rating Watch indicator should remain. Users should consult with the appropriate Fitch analysts for further guidance on treatment of bonds designated Under Analysis and other subprime bonds.

For managed synthetic transactions that use VECTOR as a portfolio management tool for purposes of the dynamic portfolio guidelines test (DPG test), the same procedures for adjusting the portfolio as described would apply. The DPG test always applies to the then-current version of VECTOR and published criteria, so these changes may affect the results of the DPG test and consequently impact the trading ability of managed transactions pursuant to the investment guidelines.

Looking Ahead

The modeling assumptions and rating committee consideration adjustments outlined in this report reflect the rapidly evolving risk landscape of recent vintage U.S. subprime RMBS. Fitch will continue to monitor market conditions and the applicability of its CDO methodology. Adjustments may be made based on actual performance versus initial expectations and other indicators of heightened ratings volatility and downgrade risk.

The VECTOR model can be downloaded from the Derivative Fitch web site at www.derivativefitch.com.

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