



2007 Global CDO and Credit Derivatives Outlook

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Introduction

Global collateralised debt obligations (“CDOs”) and credit derivatives complete another strong year in credit performance, issuance and innovations. The convergence of cash flow and synthetic technologies has been a predominant theme in 2006 and is expected to continue as the CDO and credit derivatives markets march into the New Year.

Traditional cash bond investors are crossing over into the credit derivatives space with their increasing familiarity with credit default swaps (“CDS”). Asset managers and investors are now able to take advantage of the price disparities of the cash and credit derivatives markets. The rise of hybrid transactions, which blend cash and synthetic assets and liabilities, and the launch of several structured finance (“SF”) and corporate CDS index products, have helped bring these two previously disparate set of market participants together. The launch of Derivative Fitch in October is a direct response to this dynamic synergy.

In 2006, CDOs and credit derivatives played against the backdrop of tight spreads, difficulty in sourcing collateral and other macroeconomic challenges. US CDO managers, for example, have been taking advantage of a strong domestic housing market by gradually increasing their exposures to sub-prime residential mortgage-backed securities (“RMBS”). However, fears of a US housing slowdown have also led many investors to take short positions on the residential mortgage market via CDS. Any downturn in the US economy is generally no longer confined within the country’s boundaries as foreign markets track each other more closely. Asian and European investors, for instance, have become insatiable buyers of US debt, as the structured credit markets in these continents mature.

There has been a cross-pollination of ideas between continents. The aggressively growing European leveraged loan market, for instance, has attracted US collateralised loan obligation (“CLO”) managers who aim to take advantage of the supply of and demand for high yield (“HY”) loans. Additionally, loan CDS (“LCDS”) technology has generated much attention following the International Swaps and Derivative Association’s (“ISDA”) formal release of standardised documentation in June this year. This development is expected to spur the issuance of single-tranche bespoke synthetic CLOs utilising LCDS and cash flow CLOs with buckets for synthetic assets.

Leverage seems to be a buzz word regardless of where investors are domiciled. With default rates still at historical lows, leveraged buyout (“LBO”) activity has risen in both the US and Europe, a reflection of investors’ high risk tolerance.

Separately, the appetite for commercial real estate (“CRE”) CDOs has also spread across the Atlantic, as European issuers and investors aim to replicate the success of this sector in the US.

Global CDOs fared well in the first 10 months of 2006 with 367 tranche upgrades and 188 downgrades. The 555 total rating actions taken were concentrated in the SF and investment-grade corporate CDO sectors.

US cash flow and synthetic CDO issuance (including bespoke synthetic transactions) as of Q306 is up 36% to USD281 billion from USD207bn for all of 2005. Cash flow CDOs continued to lead issuance with SF assets being the most widely-referenced collateral in portfolios. Corporate cash flow CDOs also had a healthy year as the appetite for leveraged loans remains unabated.

Similarly, in Europe, CDO issuance has reached more than EUR80bn as of October and closing in on 2005's total volume of EUR101bn. Cash flow and balance-sheet CDOs are leading the transactions being launched in euro-denominated volume, followed closely by credit derivative deals. Some 357 CDOs have been launched to date.

The CDO and credit derivatives markets in the Asia Pacific region are small in volume and most are still in their early stages. However, issuance is growing in developed markets such as Hong Kong, Singapore and Taiwan. Many market participants in the US, Europe and Asia are closely following the developments in China as the country opens up to a wider array of debt instruments.

This report reviews the most recent performance of CDO and credit derivative transactions and provides Derivative Fitch's asset performance and ratings outlooks of the deal types it covers across Europe, Asia and the US. It examines upgrade and downgrade trends and explains key rating performance drivers. The report also looks into recent structural innovations and the factors that have spurred their development. In addition, this report aims to provide a forward-looking analysis of the CDO and credit derivatives space for 2007.

Performance Summary

Global Performance Summary

Asset Class	Asset Performance	Ratings	2007 Areas to Watch
Global CDOs			
Leveraged Loans	Declining	Stable	Higher default rates and more volatile recoveries
Investment-Grade CDOs	Declining	Stable	Increasing LBO activity may result in riskier assets
High Yield CBOs	Declining	Positive	A few corporate issuers are emerging from bankruptcy and may help improve bondholders' prospects
US CDOs			
Diversified SF CDOs (Pre-2003 Vintage)	Declining	Stable to Negative	Exposure to troubled ABS sectors as well as RMBS
Mezzanine RMBS CDO	Declining	Negative	Potential deterioration for 2004-05 vintages due to home equity loan ("HEL") exposure
High Grade RMBS CDO	Stable	Stable	Credit quality shift in some recent HG RMBS CDOs
CRE CDOs	Stable	Positive	More whole loans and transitional assets included in CDOs
Trust Preferred CDOs	Improving	Positive	TruPS CDOs hitting their call periods and active refinancing among banks
Middle Market CLOs	Stable	Stable	Inclusion of buckets for broadly-syndicated loans and ABS
Market Value CDOs	Declining	Stable	MV CLOs that use total return swaps are re-emerging
European CDOs			
Structured Finance	Stable	Stable	Low excess spread levels in HG transactions
SME CDOs	Stable	Stable to Positive	Spain: More exposure to unsecured loans and second-lien mortgages, urban land and/or underdeveloped land Germany: More exposure to unsecured loans, watch emerging recovery rates

Source: Derivative Fitch

Global CDOs

Leveraged Loan CDOs

Ratings: Stable

Asset Performance: Declining

US and European leveraged loan CDO ratings have been stable and are expected to remain so over the next year. In the US, the more seasoned transactions are de-leveraging and paying off the senior noteholders. There have also been several optional redemptions, which contributed to the 48 CLO tranches being redeemed. In addition, 147 tranches were affirmed, eight downgraded and 13 were upgraded in the US. European CLOs performed in a similar manner with 106 tranches affirmed, 24 redeemed, one upgraded and no downgrades. High recoveries and low default rates have stabilised the performance of this sector in 2006.

The more recent transactions are in their reinvestment periods and are unlikely to experience rating volatility. Even if defaults increase and recoveries decrease in the underlying loan portfolios, most of the transactions have sufficient excess spread to overcome future defaults. For this reason, Fitch expects continued ratings stability despite the increasing presence of subordinated loans and corporate leverage.

Over the past few years, the leveraged loan sector has enjoyed strong corporate growth and historically low default rates. This favourable environment has also increased market participants' appetite for risk and banks' willingness to extend credit. Loan-level performance may experience higher default rates, and more volatile recoveries as senior and total debt levels rise, and credit monitoring deteriorates through weaker covenants. In addition, more complex capital structures and inter-creditor agreements could lead to greater volatility in recoveries. (Please see the reports entitled "*Recapitalized LBO Transactions: The Only Way Out?*" published on 18 January 2006 and "*Credit Quality System Eroded by Disappearing Covenants*" published on 9 August 2006 at www.fitchratings.com) The use of Fitch's leveraged loan recovery ratings ("RR") in analysing CLOs is expected to make specific recovery estimates for a CDO portfolio from future defaults resulting from these trends.

Investment-Grade ("IG") Corporate CDOs

Ratings: Stable

Asset Performance: Declining

IG corporate CDOs suffered from negative credit migration in the US automotive sector as well as general corporate credit deterioration. This deterioration resulted in the downgrade of 87 European CDO tranches as of October 2006. These downgrades represent approximately 97% of the 89 European CDO downgrades compared with 15 tranches in 2005. In the US, the number of tranches downgraded also increased to 14 tranches as of October 2006 versus 10 in 2005.

This sector is primarily composed of European synthetic transactions, including CDO squared ("CDO²") transactions, which reference other CDOs. Thirty-nine of the 87 downgrades in this sector were related to the performance of inner CDOs referencing corporate names within CDO² transactions, and an additional 16 downgrades are related to master level CDO² tranches. The master and inner CDOs combined make up 63% of European CDO downgrades to date.

Most of the negative performance is due to exposure to the US auto sector. The credit events of auto suppliers Delphi Corp. and Dana Corp, which were called after bankruptcy filings in October 2005 and March 2006, respectively, were mostly settled upon final valuation later in 2006. The downgrades of Ford Motor and General Motors, which continue to be heavily referenced, also hampered this sector's performance. In addition to auto exposure, there is an increasing trend of leveraged buyouts driven by private equity

firms. These LBO transactions often result in significant changes in corporate capital structures as well as increased risk associated with the entity's debt.

Going forward, Fitch expects declining asset performance for European and US IG corporate debt. However, the ratings outlook for the sector is stable. The IG corporate CDO sector will likely be affected by downward credit migration, increases in credit events and lower expected recoveries. However, the effect of seasoning will likely mitigate much of the deterioration. Seasoning reduces the required credit enhancement levels because transactions benefit from a reduced risk horizon when they approach maturity. If the IG corporate credit environment remains stable through the first half of 2007, then several tranches may experience upgrades due to this reduced risk horizon.

High Yield CBOs

Ratings: Positive

Asset Performance: Declining

The issuance of CDOs backed by HY bonds has stagnated in recent years as investors shied away from this sector due to underperformance. US CBOs experienced severe downgrades caused by the record number of bond defaults during the stressful credit environment in 2000-2002. There are nine CBO tranche downgrades and four upgrades as of October 2006. In April 2006, Fitch launched distressed recovery ("DR") ratings for CDOs that have been downgraded to 'B' or lower. As a result, DR ratings were assigned to 102 tranches of distressed HY CBOs.

The market for distressed debt has improved significantly in 2006 and thereby increasing the recovery expectations for many HY CBOs as companies begin to emerge from bankruptcy protection. For instance, creditors to companies such as Adelphia Communications, which filed for Chapter 11 in 2002, may benefit from asset sales or other restructurings, which may yield recoveries that are in excess of previous estimates.

Fitch is closely monitoring these developments, which could help lift the performance and improve the recovery prospects of certain CBO tranches.

The majority of CBOs are paying out, which could result in some tranches being upgraded. Fitch expects the majority of these transactions to experience clean-up calls within the next one to two years.

US

Structured Finance ("SF") CDOs

SF CDOs, including asset-backed securities ("ABS"), residential and commercial mortgage-backed securities ("RMBS" and "CMBS"), have been the largest sector in US CDOs. Approximately USD177bn of CDOs reference SF assets to the end of Q306.

In analysing the performance of SF CDOs, Fitch not only looks at the underlying collateral but also the structural features and priority of payments. SF CDOs carry nuances that are critical to their performance. For instance, SF CDO portfolios can be categorised into static, in which assets are established at the closing of the transaction and can only be removed when they prepay or default, and revolving, wherein there may or may not be a ramp-up period and the manager fully funds the asset portfolio a few months after the issuance date. Fitch also looks into the difference between high grade ("HG") and mezzanine SF CDOs, as well as the divergent performance between SF CDOs launched before 2003 and the more recent transactions.

Diversified SF CDOs (Pre-2003 Vintage)

Ratings: Stable to Negative

Asset Performance: Declining

Early vintage SF CDO performance has lagged behind newer transactions because of their exposure to troubled SF sectors. Earlier deals were more diversified and included a variety of asset- and mortgage-backed collateral in underperforming sectors such as manufactured housing (“MH”), aircraft finance loans, 12b-1 fee and equipment lease securitisations. Diversified SF CDOs took a hit during the MH industry shake-up caused by the aggressive underwriting and overbuilding in the mid-to-late 1990s. Similarly, the aircraft sector struggled with declining revenues and steeper operating costs, amid rising terrorism concerns. High exposure to these distressed sectors has resulted in weighted-average rating factor (“WARF”) migration and declining credit quality of many older vintage SF CDOs.

These CDOs have a large concentration of and severe downgrades. Although many of these early SF CDOs will soon be called, Fitch expects a stable to negative ratings performance because the de-leveraging of these deals will still be offset by their continued exposure to these underperforming sectors.

There are a total of 218 rating actions for US diversified SF CDOs that were issued before 2003, with 52 tranche downgrades, 12 tranche upgrades and 121 affirmed tranches as of Q306. Additionally, Fitch has assigned DR ratings to 45 tranches from 27 early vintage SF CDOs. The agency also withdrew its ratings from 31 tranches where it was deemed that they no longer had any economic value.

Mezzanine RMBS CDOs

Ratings: Negative

Asset Performance: Declining

High Grade RMBS CDOs

Ratings: Stable

Asset Performance: Stable

SF CDOs issued from 2003-2005 have been generally showing positive ratings performance as managers moved away from the troubled sectors that hit the earlier vintages. There are 409 tranche affirmations, 36 upgrades and no downgrades as of Q306 for SF CDOs issued from 2003 and onwards.

Unlike early vintage SF CDOs, newer SF transactions have more concentrated exposures to RMBS. Recent portfolios have up to 80% exposure to RMBS, which ties their performance closer to the changes in the housing climate.

RMBS assets found in CDOs include a mix of prime and sub-prime mortgages. CDOs have been taking advantage of the favourable US housing market in the past few years. The performance of both prime and sub-prime RMBS has been given a boost by low interest rates and appreciating house prices. In turn, this low interest rate environment has led to a spike in mortgage prepayments as borrowers refinanced their homes. This surge in prepayments paid down many RMBS structures and led to the upgrades on several mezzanine RMBS tranches. This strong RMBS performance has also fuelled the positive rating actions in several SF CDOs in the 2002, 2003 and 2004 vintages.

However, delinquencies have been rising in the prime and sub-prime RMBS sectors as strained borrowers try to keep up with rising mortgage payments. At present, more borrowers are sensitive to a slowdown in house price appreciation because of the increased amount of leverage they have assumed in recent years to afford higher house prices. Fitch’s RMBS group predicts that this increasing leverage will likely continue next year.

Spiking interest rates and the housing market slowdown may result in a much slower pace of prepayments for the 2004-05 SF CDO vintages. Fitch is closely monitoring the performance of recent transactions as they have the potential to show signs of deterioration.

The increased use of CDS in mezzanine RMBS CDO transactions may have contributed to further speculation of where the housing market is headed. Hedge funds, for instance, have been betting on a housing downturn by taking short positions on the sector, amid the ongoing debate that the slowdown is concentrated only in certain areas in the US. The recent influx of hybrid SF CDOs has also provided managers with more flexibility in selecting assets from earlier SF vintages and they are no longer just limited to the new issue pipeline.

The recent wave of SF CDOs can be classified into HG and mezzanine based on the portfolios' average credit quality. HG SF CDOs are collateralised by a pool of senior tranches typically rated 'AAA' or 'A' and include small buckets for assets rated as low as 'A-'. Mezzanine SF CDOs continue to be collateralised by mezzanine and subordinated class tranches. This is similar to the early days of the SF CDO market where the portfolios' average credit quality ranged from 'BBB' to 'BBB-'. The weighted-average coupon/spread is much lower in HG SF CDOs because of the high investment-grade rating of their underlying assets. This also limits excess spread as a form of credit enhancement for these deals. As a result, HG SF CDOs are more sensitive to changes in interest waterfall payments. Recent HG SF CDOs have no interest coverage ("IC") tests, which may have a negative effect on the future rating performance of these deals as it increases the likelihood of excess interest erosion. Fitch expects SF CDO structures to continue to evolve next year such as the case of recent mezzanine SF CDOs, which are being structured without overcollateralisation ("OC")/IC tests.

Commercial Real Estate (CRE) CDOs

Ratings: Positive

Asset Performance: Stable

Fitch rates a wide array of CRE CDOs backed by CMBS, real estate investment trusts ("REITs") and commercial real estate loans ("CREL"), as well as re-securitisations of CMBS classes ("ReREMICs"). CRE CDOs are grouped into two general classifications - CUSIP CDOs, which mainly consist of rated collateral such as CMBS and/or REIT securities, and CREL CDOs, which mostly contain unrated collateral such as whole loans, mezzanine loans and B-notes. The biggest driver of growth has been revolving CREL CDOs.

Overall, CRE CDO and ReREMIC performance has been strong with upgrades outpacing downgrades. As of Q306, 154 tranches were upgraded and only one tranche was downgraded. Generally, static CRE CDOs received the bulk of the upgrades. The performance of these deals is closely tied to their underlying assets because they are fully ramped at closing. The improving credit quality of the underlying assets, the seasoning of portfolios and de-leveraging of CDO liabilities, have contributed to the upgrades in this sector. There has been a spike in upgrades in the CMBS sector brought about by the fast pace of defeasance. A defeasance occurs when a borrower substitutes cash for the property when it sells or refinances the loans. Fitch treats defeased loans as cash and assumes the loans have paid off.

Most of the earlier CRE CDO deals are also benefiting from the shortening of the weighted-average life of their underlying assets. A shortened term will result in lower default probabilities. This means that CDO liabilities can pass at higher rating levels and result in upgrades. The de-leveraging of CDO liabilities has also contributed to CRE CDO performance. Static CRE CDOs and ReREMICs have a sequential payment feature in which proceeds from maturing assets are used to repay the most senior CDO liabilities. This feature helps increase credit enhancement to the CDO notes and ReREMIC certificates.

The few downgrades in the past few years have been to early CRE CDO vintages. The performance of these deals has been weak due to their exposure to MH securitisations. Fitch has assigned DR ratings to three tranches from two early vintage (2000) CRE CDOs and a ReREMIC. CRIIMI MAE Trust I 1996-C1, a ReREMIC, has 56% of its underlying collateral consisting of classes in the first loss position. Fitch expected losses on these bonds.

CRE CDO issuance is projected to continue to be strong next year and could double as new real estate players use the CDO vehicle to finance their lending operations. More whole loans and transitional assets are being included as this is still a largely untapped market for securitisation. Whole loans are grouped into three types: stabilised, transitional and developmental. These transitional assets are typically land projects that are in the early stages of development. Investors should be cautious when reviewing pools comprising whole loans as not all of them have the same risk profiles. They should not generally assume that these whole loan pools are less risky than B-notes/mezzanine debt.

Fitch expects fewer upgrades of ReREMICs and CRE CDOs that reference CMBS collateral as defeasance activity declines. The agency also forecasts few upgrades on the new vintage CRE CDOs, both CUSIP and CREL, as many of these deals have revolving periods. Fitch does not typically upgrade deals that are in their revolving periods because they are still likely to experience negative credit migration through trading and reinvestment. In addition, the recent CRE CDOs contain riskier assets such as condominium conversion, land and construction loans. These riskier loans are more likely to be affected in a downturn in the US economy, which could hinder the completion of construction projects and sale of condominiums, and erode property values.

Trust Preferred (“TruPS”) CDOs

Ratings: Positive

Asset Performance: Improving

TruPS CDOs are expected to maintain their strong performance in 2007. There was a single upgrade in the sector in October and no recorded downgrades. TruPS CDOs have benefited from the overall stable performance of the bank, insurance and REIT industries.

TruPS CDOs have evolved over the years from the traditional all-bank and insurance portfolios to the addition of newer collateral types such as REITs, homebuilder TruPS, single-property commercial real estate loans and middle-market loans. Fitch expects issuance to continue increasing in both deal and US dollar volume next year. Pure bank deals are slowly headed toward extinction as deals backed by multiple asset categories will dominate the space.

Fitch will be closely monitoring obligor-initiated early call activity in the next couple of years as several early-vintage TruPS CDOs exit their five-year non-call periods. Heavy refinancing activity is expected due to new opportunities for banks to take advantage of lower borrowing costs. The prepayment-driven de-leveraging of transactions is likely to have positive rating implications. But concentration risk due to adverse selection could negatively alter the credit profiles of the subordinated tranches in these deals.

Financial performance remains strong overall for major US banks. This stability may be attributed to banks' solid profitability, low asset quality problems and comfortable capital ratios. Although net interest margins remain under pressure, profitability continues to be supported by a capacity to generate non-interest income and low provisioning needs for problem loans. Overall, the US banking sector appears well-equipped in core earnings, capital and reserves to weather any possible reversal of the favourable asset quality trend.

Similarly, the insurance sector has enjoyed stable performance this year that is expected to continue in 2007. The US property/casualty insurance segment has been showing favourable and improved operating results since the first half of 2006. This strong performance reflects that rates in most business lines are still at levels adequate to produce

attractive underwriting results, despite the significant rate declines in nearly all segments through 2005 and which continued in non-catastrophe-exposed segments in 2006.

Based on first-half 2006 results and barring any unusual events, the industry is likely to meet or exceed Fitch's estimates for underwriting performance and net income for the full-year 2006. Net income and return on capital have also been boosted by higher investment yields on new premium funds.

Fitch has a positive outlook for REIT ratings for the remainder of the year and in 2007, which stems from the industry's maturation, and the effectiveness of these entities as issuers in the unsecured bond market. Fitch's view reflects the lack of defaults since the expansion of unsecured borrowing by public REITs in 1994. REITs started tapping the CDO market to access long-term committed unsecured financing since 2005 and REIT TruPS CDOs have become more mainstream since then. Fitch also expects new players to enter the REIT TruPS CDO space.

Lastly, the homebuilding sector should continue to show a stable performance in the coming decade, albeit within a cyclical context, as this is usually dependent on key economic barometers such as consumer spending, employment, inflation and interest rates.

Middle-Market CLOs

Ratings: Stable

Asset Performance: Stable

CDOs that reference middle market loans have fared well due to their stable credit quality and the rapid de-leveraging of liabilities. Fitch expects stable ratings and asset performance for middle-market CLOs for the remainder of the year and in 2007. Nine tranches were upgraded in this sector as of October 2006 and there were no downgrades. Middle-market CLOs launched between 2002 and 2004 were static, with sequential pay structures, prepayments, scheduled amortisation and maturities, that resulted in the fast redemption of senior notes. This de-leveraging enhances the credit enhancement of the subordinated notes.

More recent middle-market CLO deals have departed from sequential pay to adopt pro rata features in which principal proceeds are distributed proportionally within the capital structure. A middle-market CLO with a pro rata feature may switch to a sequential pay event if the notes remain outstanding past a given date, an interest shortfall to the notes occurs, or cumulative charged off loans exceed a given percentage of the initial collateral loan balance required for the deal to remain pro rata. Credit enhancement increases are expected when this switch happens, which in turn may result in upgrades.

In addition, recent deals have reinvestment periods for collateral managers. Trading capabilities help extend the life of middle-market CLOs because the underlying loans tend to prepay rapidly. This feature enables managers to invest the proceeds from redemptions into new collateral. Therefore, managers remain fully leveraged for a longer period, which also helps improve the execution economics of deals.

A performing deal with a revolving period tends to preserve the capital structure (de-leveraging occurs only until after the revolving period is exited), so credit enhancement levels remain constant. This stability is reflected in a higher number of affirmations for tranches in revolving middle market CLOs. The pro rata structures and revolving periods have also resulted in a significant number of affirmations in middle-market CLO tranches.

The underlying collateral for middle-market CLOs has also evolved to include buckets for syndicated loans and ABS. Recent middle-market CLO transactions have incorporated OC and IC tests, following the structure of more traditional CLOs.

Market Value ("MV") CDOs

Ratings: Stable

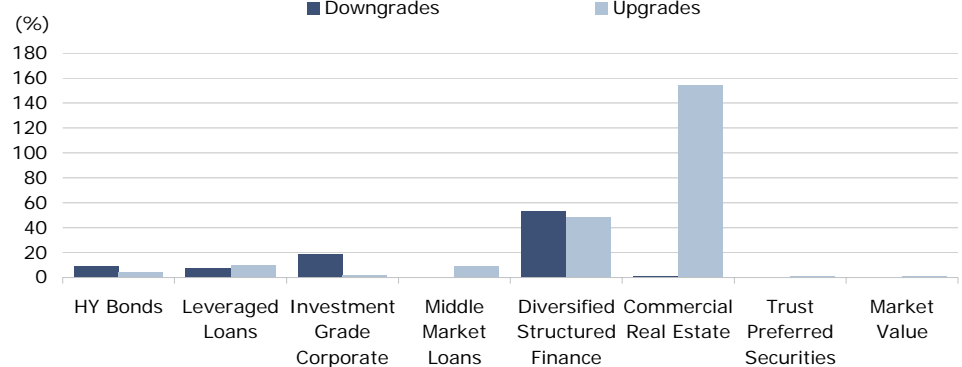
Asset Performance: Declining

MV CDOs are enjoying a revival with issuance more than doubling in 2006 from the year before. MV CDOs appeal to managers because they offer greater trading flexibility and can invest in a wide range of assets including high yield bonds and bank loans and SF securities. Unlike the earlier MV CDOs, the latest batch of transactions launched consists of more liquid assets. In addition, structural features have been added such as advance rates to help determine the amount of debt that a collateral pool can support. Overall, the sector has performed strongly this year.

One notable MV CDO segment that has re-emerged is MV CLOs that use total return swaps ("TRS") or similar structures designed to gain leveraged exposure to senior secured bank loans. TRS CLOs enable investors to access loan manager expertise, tailor leverage based on risk tolerance and specify portfolio composition requirements. However, investors are also exposed to credit, economic and MV risks. TRS CLOs incorporate mechanisms and triggers such as MV tests to divert and trap cash flows.

U.S. Rating Actions by CDO Sector

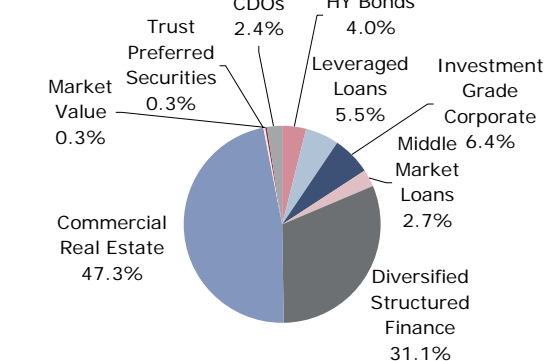
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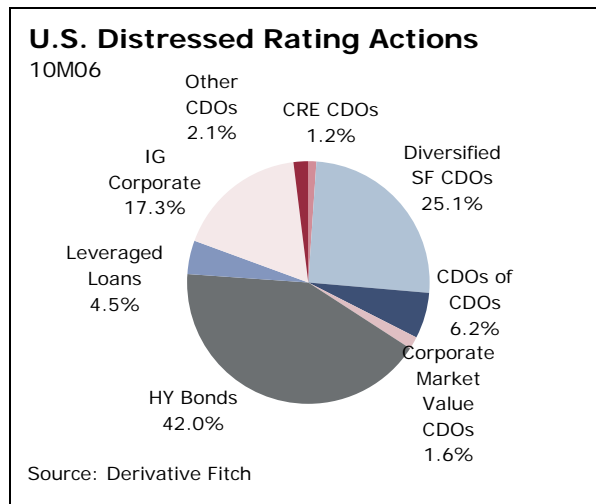
Source: Derivative Fitch

Total U.S. CDO Rating Actions

10M06



Source: Derivative Fitch



Europe

Europe's CDO market has been characterised by a continued heavy flow in commoditised CDO products, intermittent issuance in some established asset classes, and the emergence of new CDO types.

There is heavy issuance of arbitrage CLOs, which are managed by both new entrants and established managers.

This flow continues in spite of the increasing competition for assets from other institutional investors and a sharper awareness of the need for managers to discriminate between credits due to higher structural loan leverage and the unprecedented low default environment.

Continental Europe continues to originate strong balance-sheet CDO issuance from Germany and Spain. In Germany, SME CDO issuance has grown through the re-emergence of CDOs referencing granular secured loan portfolios as well as the continued growth of cash flow CDOs collateralised by less granular portfolios of loans with equity participation. The impending introduction of Basel II regulation has spawned new issuance from banks. The tentative re-emergence of mezzanine ABS CDOs during the second half of the year belies a growing pipeline for 2007, achieving the arbitrage previously lacking in these deals, through for example, the use of partially -funded hybrid structures.

Sporadic issuance in balance-sheet motivated CDOs collateralised by assets such as project finance, large loans, trust preferred/ perpetual bank and insurance debt continue to punctuate market issuance. The pipeline indicates more of these deals coming.

Much has been written about the stirrings of a real estate CDO market in Europe. The first CDO of this type closed in November. Fitch expects to see moderate issuance volumes in 2007, a potential limiting factor being the availability of underlying assets.

SF CDOs

Ratings: Stable

Asset Performance: Stable

Fitch expects European cash flow SF transactions to continue to exhibit stable ratings performance. Thirty-five tranches have been affirmed and four have been paid in full to date. There have been no upgrades or downgrades in this sector. Most of the transactions remain within their reinvestment periods and continue to perform as expected.

Moving forward, if the underlying portfolios continue to perform and transactions exit their reinvestment periods in a few years, and begin to sequentially de-leverage, then Fitch expects positive rating actions as credit enhancement levels increase. Pro rata cash flow

transactions are unlikely to experience significant positive action until the structures shift to sequential redemption mode. This is usually triggered by a failing coverage test, a pre-determined date, or a pool factor trigger, such as 50% of the initial target portfolio remaining outstanding. Although SF pro rata transactions are less likely to see upgrades, they do retain initial excess spread levels longer than sequential deals, which mean that distributions to the equity should maintain yield longer.

Synthetic transactions that reference SF instruments have benefited from increased seasoning as the risk horizon to maturity has shortened. In addition, some transactions have benefited from a reduction of leverage. For example, if transactions are past their replenishment period, then entities that reference assets that pay in full are no longer at risk. This effectively reduces risk relative to the protection provided by the first loss piece. As of the end of October, 32 tranches have been upgraded, one downgraded, eight paid in full and 29 affirmed. Fitch expects this general trend to continue.

Small- and Medium-Sized Enterprise (“SME”) CDOs

Ratings: Stable to Positive

Asset Performance: Stable

Spain and Portugal

Spanish SME CDOs have been one of the best performers in the European market, and have maintained a stable level of performance to date, with all tranches either affirmed or upgraded.

Fitch expects this stable trend to continue next year despite the economic scenario continuously changing. Interest rates and concentration risks are rising in a few industry classes. Over the course of 2007, the likely continuation of the high de-leveraging of notes and stable portfolio performance with low delinquency levels, are expected to drive further upgrades and affirmations in this sector.

As of November 2006, Fitch upgraded 13 Spanish SME CDO tranches. These actions resulted from significant increases in available credit enhancement due to the amortisation of underlying loan portfolios, and the subsequent reduction in CDO liabilities. No deals were paid in full during this period.

Mortgage assets represent most of the securitised volumes in the Spanish SF market mostly packaged in RMBS and CDOs of *cédulas hipotecarias* (“CH”), which are covered bonds backed by mortgages. CDO issuance in the country reached EUR20.9bn as of June 2006, which is in line with the same period last year and makes up approximately 50.0% of the SF issuance volume of Spain.

The collateral for SME CDO deals has been evolving. Spanish SME loan transactions have traditionally been backed by residential properties and first-ranking mortgages. However, Fitch’s securitisation team in Spain has observed a recent surge in exposures to unsecured loans and second-lien mortgages with high loan-to-value (“LTV”) ratios and shorter seasoning. In addition, there has been an increasing proportion of urban land and/or underdeveloped land in SME loan pools.

Fitch has adopted conservative assumptions for these assets in terms of potential market value declines due to the lack of historical data. Fitch Spain expects to see more of these assets included in future SME CDO transactions. By industry class breakdown, the agency has observed higher concentrations within the real estate, building and construction, and tourism sectors.

A beneficial feature found in Spanish SME transactions includes the guarantee schemes, which are applied at the tranche level, and are granted by the Kingdom of Spain (FTPYME, ‘AAA’), and by institutions such as the Generalitat de Catalunya (FTGENCAT, ‘AA-’) and the European Investment Fund (EIF, ‘AAA’).

Separately, the Portuguese market is represented by a small number of SME CDO transactions, mainly driven by three banks, namely Banco BPI (“BPI”), Banco Comercial Portugues (“BCP”) and Banco Espírito Santo (“BES”). In 2004, Promise Caravela 2004 PLC was issued and structured around the German development bank KfW’s, Promise programme. It is the second Promise transaction to reference assets outside of Germany. Promise Caravela, a synthetic deal, has been showing solid performance.

Another Fitch-rated Portuguese SME CDO, Douro SME Series 1, closed in 2005. Douro is a cash flow securitisation that was designed to switch into a static portfolio after three years of replenishment. The class B notes of the transaction are guaranteed by the EIF. Fitch has affirmed all ratings on Douro SME this year. Fitch expects more Portuguese SME CDOs to come to market as only a very small percentage of SME loans in the country have been securitised to date. Portuguese banks have also realised the benefits of securitisation as an efficient funding tool and as a way to achieve regulatory capital relief.

Germany

Aside from Spain, Germany is one of the largest markets in Europe for SME CDOs. However, issuance volumes have been subject to high volatility in recent years. After a flurry of transactions in 2000-2003, Fitch rated only one German SME CDO in 2004, while 2005 saw a total of seven transactions launched. 2006 issuance levels are the same as the year before but more transactions are expected as arrangers typically rally to close their deals before year-end.

This reverse development is due to a re-surfacing of the traditional balance-sheet SME CLOs and a strong growth in the Schuldschein (credit-linked certificates of indebtedness) and mezzanine debt SME CLOs in 2005 and 2006. These CDO types feature approximately equal numbers in transactions closing, while the volume securitised through the balance-sheet CLOs exceeds the Schuldschein and mezzanine debt CLOs. This trend is expected to continue in 2007.

This growth reflects the changes in the structure of and motivation for SME securitisations in Germany. It has been the result of a number of legislative changes in the country, such as the abolition of trade taxes applicable to true sale transfers of loans that are originated by banks.

While early vintage SME CDOs are based on synthetic securitisations of large replenishing loan portfolios via the KfW platform (Promise programme), the new type of SME CDOs involves a true-sale of small static loan portfolios.

The Promise transactions, as well as Deutsche Bank’s CAST 1999-1, 2000-1 and 2000-2 deals, which are almost identical in structure, have all shown remarkably stable performance over the past years, even though the macroeconomic climate has been subdued and there have been record defaults of companies in Germany, according to the German Statistics Agency.

The guidelines and eligibility criteria that govern portfolio replenishment have provided an effective filter for loan selection and have resulted in most transactions maintaining their weighted-average rating quality that is close to the initial credit quality. A small number of transactions incurred relatively large amounts of defaults in their reference portfolios, particularly in two cases, where the transactions turned static. However, as a result of very high recovery rates, none of the transactions became impaired. During the course of the year, 31 tranches from four transactions have been redeemed, either as they reached their scheduled maturity or were subject to an early call option. All of the notes have been paid in full.

To date, only seven tranches have been downgraded over the course of several years. Meanwhile, Fitch has upgraded 18 tranches and affirmed all others. In November 2006, five more tranches have been upgraded as these transactions completed their replenishment period in October.

For 2007, Fitch expects to see a continuation of this positive performance with more transactions reaching scheduled maturity and some further upgrades.

On the other hand, the new generation of SME CDOs has been hit by the default of Nici AG, a maker of soft toys, which filed for bankruptcy in May 2006. Nici AG was included in three Fitch-rated transactions, PREPS 2004-2, PREPS 2005-1 and FORCE 2005-1, and the default event occurred shortly after they closed.

In July 2006, one more company defaulted. This company was only referenced in one transaction, not rated by Fitch. As portfolios on mezzanine and Schuldschein CLOs are concentrated, the impact of a single default can be much more severe. The recovery rate on this type of loan is expected to be very low. However, the built-in structural protection has proven sufficient and no negative rating action was taken as a result. While it is difficult to judge future performance based on such a short history, Fitch is not aware of any fundamental credit issue and expects stable performance from this transaction type.

Italy, Switzerland and Austria

Italy, Switzerland and Austria all represent a small share of the SME CDO securitisation market in Europe and issuance has been mainly done on an ad hoc basis.

In Italy, the transactions PMI Uno Finance S.r.l. and Due PMI 2 Finance S.r.l. were issued in 2004, and were followed only in 2006 by one other SME CDO, Atlante Finance S.r.l. This recent transaction is a securitisation of a “mixed portfolio” of loans to Italian companies and individual entrepreneurs, as well as residential mortgage and unsecured loans to local Italian public entities.

The Italian securitisation market is showing much promise and issuance volumes may increase next year and in 2008. The current wave of Italian bank mergers is likely to put pressure on banks’ capital ratios and would motivate them to tap the CDO market for capital relief. The Italian economy is also recovering, which will likely increase the demand for banks’ credit and build up portfolios to be securitised. In addition, Basel II implementation could push banks to tap securitisation as an efficient way to manage credit portfolio risk.

Helvetic Asset Trust II Limited (“HAT II”), rated by Fitch in 2003, is the sole transaction from Switzerland. Since then, all ratings have been affirmed due to the stable performance of the deal. As a synthetic securitisation, HAT II is comparable to the Promise deals, but does not use the KfW platform. Instead, it invests the proceeds of the note issuance into commercial paper and enters into a repurchase agreement with UBS AG. The transaction also features a fixed recovery rate of 55%, which ensures that defaults are settled within one payment period.

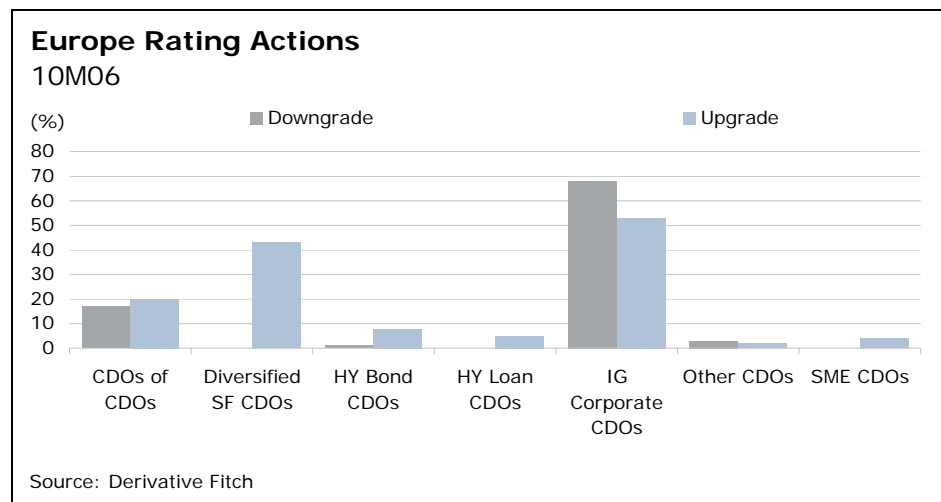
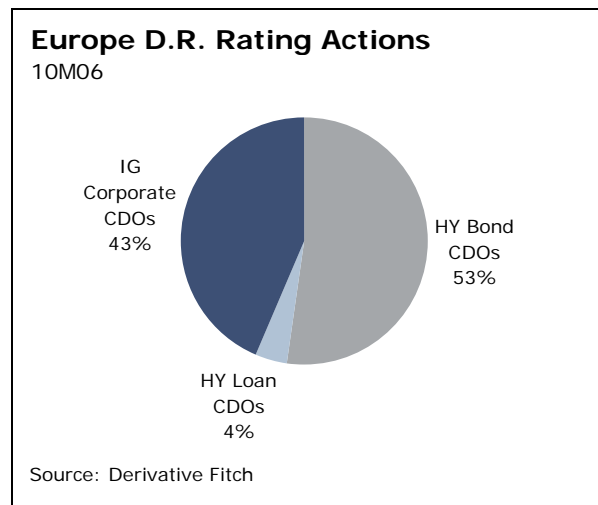
During 2006, the only Austrian SME CDO, Promise Austria 2002 Plc, has been redeemed subject to an early call option. Promise Austria was the first deal to be issued out of the Promise programme outside of Germany. It was also the first ever deal issued by an Austrian bank referencing SME loans. The referenced portfolio was covenanted to a fixed amortisation schedule, which is also unusual for the transactions issued under the Promise programme. Promise Austria showed sound performance and Fitch had affirmed all ratings at their initial levels.

All notes were fully redeemed.

Belgium, Netherlands and Luxembourg (Benelux)

Fitch has rated three SME CDOs out of the Netherlands, Smile Securitisation Company 2001-1 BV, Mars 2004 BV, Smile 2005 Synthetic BV, and one transaction from Belgium called Park Mountain 2002-1 BV. The latter involves a mixed portfolio including SME loans from mainly Belgian and Dutch obligors and to a smaller degree from other European countries. Smile 2001-1, being the most seasoned of this group, has recently been upgraded due to its stable performance and an increase in credit enhancement as a result of

prepayments, which caused the de-leveraging of the notes. Issuance volumes in the Benelux region are expected to remain at the current level.



Asia Pacific

The outlook for the Asia Pacific CDO (“APCDO”) market next year varies by country but is generally positive. Fitch expects significant momentum in the APCDO arena to continue with increased investor interest in the full range of structured credit products. Arranging banks in the region show their commitment in this space by hiring more staff.

Hong Kong and Singapore

In the synthetic space, CDO issuance in Hong Kong and Singapore has been dominated by single-tranche CDOs that are arranged for clients, largely in North Asia. However, arranging banks are focused on the full gamut of structured credit products, including credit constant proportion portfolio insurance (“CPPI”), CPDOs and commodity-linked CDOs.

Singapore-based CDO asset managers are expected to continue to be active in managing a growing number of transactions given the strong interest in regionally-managed cash and synthetic CDOs. In addition, in 2006, this community launched a number of transactions on its own behalf. These deals include UOB Asset Management’s Raffles Place Funding II (HG US ABS), Lion Capital’s Singa Funding Limited (HG US ABS), and ST Asset Management’s Orchid III (Mezzanine ABS) and Istana High Grade ABS CDO 1. Prudential Asset Management also launched Silk Road Plus, a managed global synthetic CDO. The portfolio has approximately 50% credit exposure to Asian entities.

With the looming Basel II accord, balance sheet optimisation has been gaining ground among financial institutions with exposure in Asia. As a result, Fitch expects more balance-sheet CLO issuance from regional Asian banks seeking to transfer part of their corporate credit risk. For example, in 2006, Standard Chartered Bank issued Start CLO II and Start CLO III, which are synthetic securitisations of its wholesale banking loan portfolio. Approximately 63% of the borrowers were from Asia Pacific in Start II CLO, while Start III portfolio had a higher exposure at 80%. In contrast, Start CLO I, which closed in November 2005, had 39% of its initial portfolio from Asia Pacific.

Additionally, domestic banks in Singapore are interested in securitising parts of their balance sheets, following DBS Bank's SME CreditAssist transaction. The deal closed in April 2006 and is a cash flow securitisation of a static pool of secured and unsecured loans extended by DBS to SMEs in Singapore. The objective of the transaction was to broaden the funding sources for SMEs in Singapore and to serve as the pilot project for further issuance.

Taiwan

Fitch expects locally originated CDO issuance in Taiwan to be strong with more asset-backed commercial paper ("ABCP") coming to market more regularly than term notes. Further growth of Taiwan's ABCP market will be fuelled from both the supply and demand sides.

CLOs backed by domestic balance-sheet corporate loans and with liabilities issued either via term notes or ABCP are expected to gain more popularity. Most domestic banks, many of which have exhausted their lending capacity for specific industries and obligors, deem CDO technology a solution to rebalance their portfolios and to enhance the efficiency of their capital utilisation.

CDO issuance driven by structured bonds that include US dollar-denominated assets such as RMBS CDOs, principal-protected notes or even principal-only securities may continue to contribute to issuance next year.

The recent announcement by the Financial Supervisory Commission ("FSC"), which affirmed the 35% cap on foreign investments that Taiwanese insurance companies can make as a percentage of their total portfolio, may limit the amount of new CDOs such investors can buy in 2007. Many of these investors are already at or close to this 35% limit and had initially expected the cap to increase to 50%. This may provide the impetus for greater investment in locally originated Taiwanese dollar-denominated CDOs.

The Taiwanese investor base has continued to be active in buying US synthetic CDO deals, including managed synthetic CDOs. These high yielding US dollar-denominated assets are typically repackaged with Taiwanese dollar-denominated structured notes as part of a CBO issuance.

Fitch rated most of the Taiwanese ABCP transactions that were issued in 2006, which totalled approximately TWD48.17bn of issuance. Fitch also rated the first Taiwanese ABCP transaction backed by a local insurer called Taiwan Life 2006-1 ABCP Securitization Trust. This transaction is likely to provide the impetus for other Taiwan-based insurance companies on how to advance their risk-return profiles through CDO technology.

Korea

Fitch expects structured credit products to continue to gain appeal in Korea given institutional investors' interest in managed synthetic CDOs, credit CPPIs and CPDOs. Discussions continue among market participants about the potential of a domestic CDS market developing.

Like Taiwan, Korean investors have continued to purchase bespoke single-tranche static synthetic CDOs. In general, Fitch has noted that despite the high level of interest shown in

structured credit products, particularly for credit CPPIs and CPDOs by domestic financial institutions and insurance companies, the knowledge base of many Korean investors in synthetic securitisations is limited.

Fitch has observed that Korean CDO institutional investors have shown a clear preference for managed CDOs and have expressed a strong interest in CDO and asset manager ratings.

Korea continues to have an active domestic cash flow CDO market with regular issuance throughout the year.

Japan

Fitch believes that the clarified accounting treatment of synthetic CDOs under the new generally accepted accounting principles (“GAAP”) will significantly increase the number of potential CDO investors in Japan. In particular, regional banks are likely to increase their CDO investments.

There was uncertainty surrounding the treatment of CDOs under the initially proposed Japanese GAAP, which was finally released in March. The requirement to exempt CDOs from bifurcation was modified from the first exposure draft, which had required a minimum of a ‘AA’ or higher rating from multiple rating agencies. The final GAAP removed such rating requirements entirely and gave clarification to the market.

Fitch expects a trend towards more managed deals as CDO asset managers promote the benefits of the additional flexibility they can provide to longer dated transactions that reference international names.

In addition, Fitch expects that innovative structured products will be heavily marketed in Japan next year. There is already evident interest in products such as credit CPPIs, CPDOs, commodity CDOs and CRE CDOs. Japan is the first Asia Pacific country to have shown interest in the CRE CDO product.

Cash flow CDOs continue to show a very stable performance as was the case in 2005. However, synthetic CDOs referenced to diversified portfolios of global corporate names were subject to credit deterioration largely due to multiple-notch downgrades of US entities as a result of LBO activity. However, in most of these synthetic CDOs, the impact of such credit deterioration has been offset by increased surplus credit enhancement arising from time-decay.

Australia and New Zealand

Fitch expects that the structured credit market will continue to grow significantly in 2007. Although no cash CDO deals were originated in 2006, there has been a notable growth in structured credit in the region. There have been several synthetic single-tranche transactions of both corporate and ABS exposures, as well as an expansion into synthetic balance-sheet CLOs. Domestic banks have launched deals such as ANZ Bank’s AUD2.1bn Resonance Funding Series 2006-1 deal and National Australia Banks’ AUD1.9bn Southern Cross 2006-1 Script Securitisation Limited. The banks are using these CLOs as a means to free up regulatory capital. These CLO transactions follow the issuance in late 2005 of NAB’s first Southern Cross synthetic balance-sheet CLO.

At the same time, there has been strong demand for innovative structured credit products from retail investors looking to diversify their portfolios. Arranging banks have therefore heavily marketed complex products such as CPDO and CPPI notes to both Australian and New Zealand investors.

China

There has been negligible CDO activity in China to date aside from China Development Bank’s follow-up balance-sheet cash CLO in April this year.

Fitch expects an increase in cash flow CLO issuance in 2007 following the State Council's (Chinese cabinet) approval for further securitisation trials and the Ministry of Finance's release of tax treatment rules. The underlying loans in the new securitisation trials may be expanded to include non-performing loans. There are currently a number of large commercial banks and asset management companies preparing their cash CLO pipeline.

The lack of CDS activity in China on both Chinese and international names has limited the market's understanding of synthetic CDO structures. Furthermore, the China Banking Regulatory Commission is still in the process of specifying the types of institutions that are specifically allowed to invest in domestic CDOs. However, a small number of Chinese banks have invested in global CDO products.

India

A number of arrangers are currently working on all-India CLO transactions in both synthetic and cash format. Arlo IV Limited – Ganges Synthetic CDO - is a managed synthetic CDO of all-India assets. Fitch expects the Indian CDO market to grow in 2007 given that significant Indian rupee-denominated assets are held offshore. In addition, the active single loan sell-down market (also known as private loan transfers) could easily become the predecessor to active and regular structured credit domestic issuance such as first-to-default transactions.

CDOs have yet to establish themselves firmly in India. Only a small number of institutional investors, such as financial institutions through their offshore office, have invested in CDOs to date.

Malaysia

If the Malaysian Central Bank lifts its current ban on its banks buying global CDOs, Fitch expects that this will pave the way for more CDO activity in the country. Furthermore, Fitch expects that there will be further issuance of domestic cash CLO transactions.

Domestic CDO issuance during the year included Alliance Investment Bank Bhd's securitisation of a portfolio of 25 new loan facilities totalling RM800m under the Idaman CLO transaction. The overall CDO knowledge base in Malaysia, in particular for synthetic CDOs, remains limited.

Thailand

Fitch expects increasing interest from the major commercial Thai banks, which have been given clearance in recent years to invest in CDOs, albeit at a measured pace.

During the course of the year, Fitch has noted that while only a few Thai commercial banks have made initial investments in CDOs, there is noticeable interest among market participants in the country.

Looking Ahead – 2007

CDO market participants are bracing themselves for the coming year. Performance is driven by a variety of technical and fundamental factors and 2007 will be a test of the structural soundness of many of these CDO types. In the US, the heavy flow of RMBS CDOs has further ignited the debate about the direction of the housing market and how recent transactions can withstand any downturn. CRE CDOs continue to be one of the sweet spots in US SF and its growth in Europe holds much promise. Global investment-grade corporate CDOs are still feeling the after-effects of the auto industry's financial troubles but ratings performance has so far held steady. Similarly, global leveraged loan CDOs have maintained ratings stability but Fitch also cautions on the potential for higher default rates and volatile recoveries.

There are various innovations in store for the global CDO and credit derivatives markets in the coming year. US, European and Asia Pacific issuers and investors have developed a more sophisticated knowledge base and are looking for more creative ways to package

debt. The three continents have been moving closer to each other in innovations, albeit at a different scale and in different jurisdictions.

Newer investment vehicles such as credit CPPIs and CPDOs, which provide leveraged exposure to portfolios, are expected to gain appeal in all three regions. Corporate and ABS leveraged super senior transactions are also here to stay, especially in Europe and in the US, where arranging banks expect to be busy in the coming year. Several index-based products have been launched this year and have expanded the investor base and provided another avenue for CDS exposure.

All of these transactions carry both credit and market risks and this has fuelled the need for more advanced rating and surveillance analytical tools. Derivative Fitch has kept abreast of these developments by launching analytical platforms that address both ratings and pricing volatility.

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