

Special Report

Financial Guarantors — Matrix Hypothetical Subprime Stress Test Results

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Related Research

- “Financial Guarantors — Fourth-Quarter 2006 Matrix Capital Model Results,” dated Sept. 6, 2007
- “The Fitch Matrix Financial Guaranty Capital Model,” dated Jan. 9, 2007
- “Rating Stability of Fitch-Rated Global Cash Mezzanine Structured Finance CDOs with Exposure to U.S. Subprime RMBS,” dated April 2, 2007

■ Introduction

Fitch Ratings has completed a “stress test” against the capital adequacy of the financial guaranty industry under a hypothetical assumption in which there is material adverse ratings migration with respect to subprime mortgage-related exposures within the financial guarantors’ insured portfolios. The results indicate a strong resiliency on the part of the financial guaranty industry to maintain very strong capital levels even if significant ratings migration were to occur.

While a few financial guarantors’ Core Capital Adequacy Ratios under our Matrix capital model fell below the standard for their ratings levels under the stress test, this does not have any immediate rating implications, since ratings are based on the “standard” Matrix results concurrently published today (see “Financial Guarantors — Fourth-Quarter 2006 Matrix Capital Model Results,” dated Sept. 6, 2007). What the stress test indicates for these companies is that should ratings migration prove worse than expected, as defined by the stress test, they would need to find ways to either raise capital, or mitigate risks in other manners (slowed growth, reinsurance, etc.), in order to continue to meet rating levels consistent with our published criteria.

■ Background

The U.S. subprime mortgage shakeout of 2007 has directly or indirectly impacted a number of sectors of the global economy. Within the United States in 2007, we have already witnessed a significant number of bankruptcy filings of major independent mortgage originators. The subprime shakeout has also negatively impacted a number of rated subprime residential mortgage-backed securities (RMBS) and collateralized debt obligations backed by a large concentration of RMBS (ABS-CDOs), particularly those transactions from the vintage years 2005 and 2006.

As part of their business, financial guarantors insure subprime RMBS and ABS-CDO transactions. Based on the most recent Matrix capital model update for the financial guaranty industry (see special report entitled “Financial Guarantors — Fourth-Quarter 2006 Matrix Capital Model Results,” published Sept. 6, 2007, available at www.fitchratings.com) the sector maintained \$66.2 billion of aggregate gross par exposure to subprime RMBS and \$69.6 billion to ABS-CDOs. (For Matrix modeling, Fitch combines exposure to Alternative A (Alt-A) RMBS with exposure to subprime RMBS, and the \$66.2 billion aggregate exposure reflects the combined total.) (See Appendix III on page 7.)

As has been discussed in previous publications, Matrix is designed to measure a company’s capital adequacy assuming a severe economic

stress. In addition, those most severe stress scenarios in Matrix have been supplemented by a process known as “regime shift,” which allows Matrix to incorporate unknown or unforeseen credit events into its economic stress. The regime shift process within Matrix, which occurs in 2% of all iterations, effectively stresses the structured finance portfolios by one full rating category on both a default risk and recovery risk perspective (see criteria report entitled “The Fitch Matrix Financial Guaranty Capital Model,” dated Jan. 9, 2007, available at www.fitchratings.com).

With that said, Fitch recognizes the effectiveness of Matrix will be based on the data driving the model. One of the major variables driving Matrix is the underlying ratings within the insured portfolios. By definition, the lower the underlying ratings, the greater the probability of default, and subsequently the higher the required capital needed to support the business at a given rating stress.

Given the number of downgrades that have been experienced in subprime RMBS and ABS-CDOs, Fitch has been asked on numerous occasions how the financial guarantors’ capital positions would appear under Matrix in the event the underlying subprime RMBS and ABS-CDO ratings decline from their current levels. The market’s concern in many ways seems to be less whether subprime losses would result in the insolvency of a financial guarantor, but instead if either losses or ratings migration in the insured portfolio would cause a downgrade in the insurer financial strength (IFS) rating of the guarantor. A downgrade in the IFS rating would lead to a concurrent downgrade in the insured rating of all of the securities wrapped by the guarantor.

■ Hypothetical Subprime Stress

Fitch does not envision significant negative ratings migration for the majority of the existing subprime RMBS or ABS-CDO exposures insured by the financial guarantors. With respect to subprime RMBS, the majority of the exposures underwritten in the past few years have been insured at attachment points at or above ‘A’ rating levels, with a sizeable percentage underwritten at ‘AAA’ attachment points. As has been seen to date, the majority of the rating downgrades on subprime RMBS securitizations have been done on securitization classes rated ‘BBB’ or less.

For ABS-CDO exposures, Fitch takes comfort from the fact financial guarantors’ exposures are in the senior-most positions in the capitalization structure. Additionally, almost all transactions underwritten since 2005 have been executed at the ‘AAA’ rating level, with a high percentage of these deals being insured at attachment points well

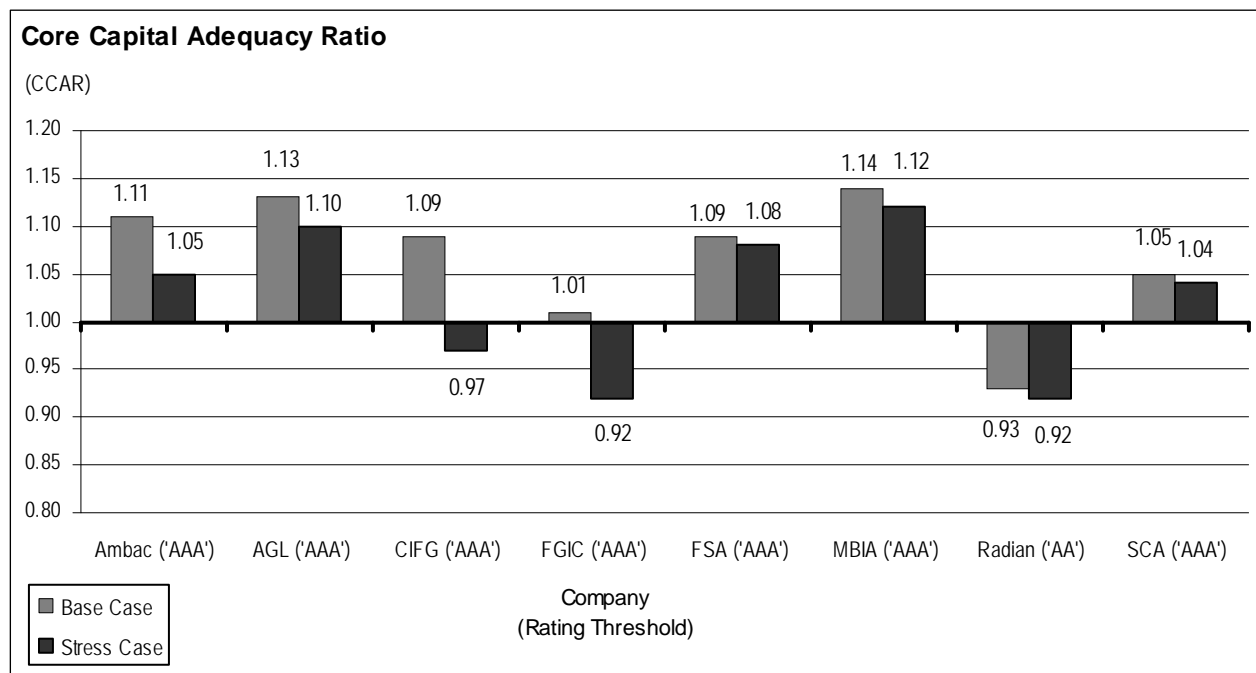
Subprime Stress Assumptions	
Subprime RMBS	
Population Assumptions	
2005 and 2006 vintages	
U.S. Collateral	
Includes Subprime RMBS, Alt-A RMBS, and Net Interest Margin transactions	
Stress Criteria	Stress
‘AAA’ “Last Cash Flow” transactions	Two-notch downgrade to current rating (i.e., ‘AAA’ to ‘AA’)
Transactions rated lower than ‘AAA’ and higher than ‘BBB+’	Two-notch downgrade to current rating
Transactions rated ‘BBB+’ and below	Three-notch downgrade to current rating
ABS-CDO	
Population Assumptions	
Static transactions originated in 2005 and 2006	
Managed transactions originated in 2002–2006	
Stress Criteria	Stress
Transactions with original CE lower than 1.25x minimum ‘AAA’ threshold	Four-notch downgrade to current rating
Transactions with original CE of 1.26x to 1.50x minimum ‘AAA’ threshold	Two-notch downgrade to current rating
Transactions with original CE greater than 1.50x minimum ‘AAA’ threshold	One-notch downgrade to current rating
All transactions	Recovery rate stress
RMBS – Residential mortgage-backed securities. ABS – Asset-backed securities. CDO – Collateralized debt obligation. CE – Credit enhancement.	

above minimum ‘AAA’ thresholds. Oftentimes, these exposures are insured at attachment points that are 50%–200% higher than the minimum ‘AAA’ threshold. As an example, if the most junior ‘AAA’-rated class in a given ABS-CDO required 10% credit enhancement to initially be rated ‘AAA’, many of the exposures insured by the financial guarantors would have had 15%–30% credit enhancement. This means there would have to be significant deterioration in a given transaction before the security wrapped by the financial guarantor would be subject to a downgrade, let alone a potential claim.

While Fitch remains comfortable with the insurers’ exposures to the transactions in these sectors, the agency felt for hypothetical purposes it would be informative to model a stress assuming future deterioration to subprime RMBS and ABS-CDO exposures insured by the financial guarantors. Since the test is strictly hypothetical and does not reflect Fitch’s current expectations, results from this test are not factored into the ratings of the financial guarantors. Rather, this stress test is meant to provide a perspective on how a given company’s capital position might perform in the unlikely event these severe stresses came to be realized. The table on page 2 defines the enhanced stresses Fitch has incorporated into the insured portfolios of each financial guarantor rated by Fitch.

For purposes of this exercise, Fitch only stressed RMBS and ABS-CDO exposures that had the potential to be directly impacted by 2005–2006 vintage collateral. “Subprime RMBS” exposure for this stress test was broadly defined to include exposure to Alt-A RMBS and net interest margin transactions (which are generally based upon subprime RMBS), in addition to RMBS transactions that would generally be categorized as subprime. The amount of the stress applied to this group of transactions correlated directly to the existing rating of the insured exposure. In general, the lower the existing underlying rating, the greater the amount of the current stress.

ABS-CDO exposure for this stress test included static transactions originated in the 2005–2006 period and managed transactions originated in the 2002–2006 period. A longer period was used for managed transactions because they generally include a revolving period during which transaction cash flow is reinvested into new collateral. Thus, for example, the current collateral composition of a 2003 vintage ABS-CDO could include 20% exposure to 2006 vintage RMBS (refer to “Rating Stability of Fitch-Rated Global Cash Mezzanine Structured Finance CDOs with Exposure to U.S. Subprime RMBS,” dated April 2, 2007). Within the selected group of static and managed transactions, the existing underlying rating of a financial guarantor’s exposure was the starting point for determining stress. However, since the majority of these exposures have underlying ratings of ‘AAA’, a further differentiator for



ratings stress was based upon the initial multiple of minimum 'AAA' credit enhancement. If initial credit enhancement for the most junior 'AAA' class in a transaction was 10% and the financial guarantor's exposure attached at 15% credit enhancement, then the minimum 'AAA' multiple for the financial guarantor's exposure was 1.5x. In the stress scenario, exposures with lower 'AAA' multiples were stressed to a greater degree than exposures with higher multiples, as detailed in Subprime Stress Assumptions chart on page 2.

In addition to the rating stress applied to ABS-CDO exposures to capture increases in default risk, Fitch also applied a stress against assumed recovery rates (given default) for these transactions. For ABS-CDOs in this hypothetical exercise, Fitch increased the stress on recovery rates by one rating category. The Matrix model bases recovery rates for structured finance transactions on original transaction ratings, and the mean recovery rate for an ABS-CDO with an original rating of 'AAA' would decrease from 88% to 75% if the original rating is reduced one rating category to 'AA'. (For a more comprehensive explanation of the recovery process in Matrix, please refer to the criteria report entitled "The Fitch Matrix Financial Guaranty Capital Model," dated Jan. 9, 2007, available at www.fitchratings.com.)

■ Hypothetical Stressed Results

The chart on page 3 summarizes the results from the theoretical stress. These stressed results are then compared to the base model results produced in the separate special report released today. The stress in this report includes all portfolio data as of year-end 2006. Fitch recognizes that additional exposures have been underwritten in 2007, although these deals have not been incorporated into this model stress.

Based on the data, companies that already maintained healthy levels of excess capital generally fared well in the stress test, maintaining more than enough capital to support their 'AAA' ratings. The company that was least impacted in the stress test was Financial Security Assurance Inc., as this company has a very modest exposure to the stressed sectors compared to the rest of the financial guaranty industry. CIFG Financial Guaranty was the only company that produced a high level of excess capital in the original base results, and then subsequently produced levels modestly below 'AAA' standards in the stress test. That is mainly due to this company's sizeable concentration of ABS-CDOs relative to its current capital base. Financial Guaranty Insurance Company (FGIC) also fell below 'AAA' in this hypothetical stress test, although this was due to a CCAR in the base case just slightly above the 'AAA' floor, combined with a relatively large exposure to RMBS and ABS-CDOs relative to its capital base.

To stress the portfolios even further, Fitch ran an additional test that effectively doubled the levels of hypothetical stress on ABS-CDO exposures from the levels used in the initial stress test. Although Fitch is not publishing the results of this additional stress, this further test resulted in ABS-CDO losses that were between 150%–200% higher than the previous stress test produced. Again, while Fitch views these scenarios as being highly remote, test results indicate that companies with a healthy level of excess capital, or minimal exposure to the affected subsectors, should be able to effectively manage their risks and ultimately maintain their existing ratings.

■ Conclusion

Fitch conducted these hypothetical stress tests particularly in response to investor inquiries regarding potential implications of financial guarantors' exposures to risks associated with subprime RMBS transactions. The tests were undertaken purely to provide a hypothetical perspective, and the results will not be factored into the current ratings of any of the financial guarantors rated by Fitch. Fitch's assessment of each company's capital position continues to be based on its "standard" Matrix model results—which were published concurrently with this report. Although the results of these tests do not impact current ratings, they do provide some informational value that it is hoped will be responsive to some of the questions Fitch has received over recent weeks. Fitch believes the Matrix model is a useful analytical tool to assess hypothetical scenarios of this kind discussed in this report and expects to continue to expand its use of Matrix in this way.

Finally, it should be emphasized that results of hypothetical stress tests of this kind should be considered within the context of the financial guarantors' business model. Ratings stresses of individual exposures or groups of exposures may ultimately have implications for capital adequacy. However, actual claim payments by financial guarantors are caused by cash shortfalls within insured transactions, not from a decline in the credit rating or market value of the

transaction. Also, the financial guarantors are not required to collateralize their insured exposures as a result of declines in the market value of the underlying transactions. This is an important point of difference when comparing the financial guaranty companies with competing credit enhancement vehicles. If financial guarantors were subject to such market value risk, they would not be able to achieve ratings as high as 'AAA'.

Appendix I — Base Case Capital Adequacy

(\$000, As of Dec. 31, 2006)

Rating Threshold	'AAA'	'AAA'	'AAA'	'AAA'	'AAA'	'AAA'	'AA'	'AAA'
	Ambac	AGL	CIFG	FGIC	FSA	MBIA	Radian	SCA
Policyholder Surplus	3,712,015	1,027,000	565,810	1,130,800	1,543,113	4,352,756	1,001,256	1,595,000
Losses and LAE Reserves	42,458	33,000	—	28,200	52,964	100,645	53,966	82,000
Unearned Premiums	3,373,373	683,000	282,291	1,378,900	2,070,751	3,649,918	826,519	595,000
Contingency Reserves	2,685,614	631,000	102,546	1,274,300	1,011,034	2,478,064	336,719	21,000
Equity-Like Soft Capital (1)	800,000	200,000	101,500	300,000	200,000	400,000	150,000	200,000
Discounted PV Installment Premiums	2,404,830	586,000	277,934	630,800	827,916	2,205,433	351,432	399,000
Total Claims-Paying Resources	13,018,290	3,160,000	1,330,081	4,743,000	5,705,778	13,186,816	2,719,892	2,892,000
Required Capital for Factor-Based Charges (2)	(932,839)	(234,330)	(56,855)	(232,995)	(684,696)	(1,056,621)	(94,287)	(147,928)
ACPR	12,085,451	2,925,670	1,273,226	4,510,005	5,021,082	12,130,195	2,625,605	2,744,072
Simulated Portfolio Losses	11,949,707	2,459,007	1,080,401	4,434,617	5,599,819	12,090,724	2,701,863	2,716,273
Runoff Expenses	450,559	152,596	101,648	280,773	498,733	599,094	115,093	174,489
Reinsurance and Soft Capital Credit	(1,496,537)	(20,242)	(12,488)	(244,160)	(1,478,337)	(2,041,109)	(5,425)	(288,361)
RCPR	10,903,729	2,591,362	1,169,561	4,471,230	4,620,216	10,648,709	2,811,530	2,602,400
Core Capital Adequacy Ratio (x) (3)	1.11	1.13	1.09	1.01	1.09	1.14	0.93	1.05
Excess Capital	1,181,722	334,308	103,665	38,776	400,866	1,481,486	(185,926)	141,672

LAE – Loss adjustment expense. PV – Present value. ACPR – Adjusted Claims-Paying Resources. RCPR – Required Claims-Paying Resources. Ambac – Ambac Assurance Corp. AGL – Consolidated Assured Guaranty Corp. and Assured Guaranty Re Ltd. CIFG – CIFG Guaranty. FGIC – Financial Guaranty Insurance Company. FSA – Financial Security Assurance Inc. MBIA – MBIA Insurance Corp. Radian – Radian Asset Assurance Inc. SCA – Consolidated XLCA and XLFA. See Appendix VI — Explanation of Ratios in Appendices I and II, page 8.

Appendix II — RMBS Stress Case Capital Adequacy

(\$000, As of Dec. 31, 2006)

Rating Threshold	'AAA'	'AAA'	'AAA'	'AAA'	'AAA'	'AAA'	'AA'	'AAA'
	Ambac	AGL	CIFG	FGIC	FSA	MBIA	Radian	SCA
Policyholder Surplus	3,712,015	1,027,000	565,810	1,130,800	1,543,113	4,352,756	1,001,256	1,595,000
Losses and LAE Reserves	42,458	33,000	—	28,200	52,964	100,645	53,966	82,000
Unearned Premiums	3,373,373	683,000	282,291	1,378,900	2,070,751	3,649,918	826,519	595,000
Contingency Reserves	2,685,614	631,000	102,546	1,274,300	1,011,034	2,478,064	336,719	21,000
Equity-Like Soft Capital (1)	800,000	200,000	101,500	300,000	200,000	400,000	150,000	200,000
Discounted PV Installment Premiums	2,404,830	586,000	277,934	630,800	827,916	2,205,433	351,432	399,000
Total Claims-Paying Resources	13,018,290	3,160,000	1,330,081	4,743,000	5,705,778	13,186,816	2,719,892	2,892,000
Required Capital for Factor-Based Charges (2)	(950,586)	(236,826)	(31,028)	(243,200)	(685,983)	(1,050,250)	(94,944)	(148,428)
ACPR	12,067,704	2,923,174	1,312,094	4,499,800	5,019,795	12,136,566	2,624,948	2,743,572
Simulated Portfolio Losses	12,553,949	2,520,943	1,241,475	4,866,630	5,639,832	12,278,787	2,743,022	2,759,552
Runoff Expenses	450,559	152,596	101,648	280,773	498,733	599,094	115,093	174,489
Reinsurance and Soft Capital Credit	(1,514,172)	(20,367)	(31,028)	(260,318)	(1,490,378)	(2,055,975)	(5,441)	(287,895)
RCPR	11,490,335	2,653,173	1,312,094	4,887,085	4,648,187	10,821,906	2,852,674	2,646,145
Core Capital Adequacy Ratio (x) (3)	1.05	1.10	0.97	0.92	1.08	1.12	0.92	1.04
Excess Capital	577,369	270,001	(41,847)	(387,285)	371,608	1,314,660	(227,727)	97,427

LAE – Loss adjustment expense. PV – Present value. ACPR – Adjusted Claims-Paying Resources. RCPR – Required Claims-Paying Resources. Ambac – Ambac Assurance Corp. AGL – Consolidated Assured Guaranty Corp. and Assured Guaranty Re Ltd. CIFG – CIFG Guaranty. FGIC – Financial Guaranty Insurance Company. FSA – Financial Security Assurance Inc. MBIA – MBIA Insurance Corp. Radian – Radian Asset Assurance Inc. SCA – Consolidated XLCA and XLFA. See Appendix VI — Explanation of Ratios in Appendices I and II, page 8.

Appendix III — Total RMBS: Subprime and ABS-CDO Gross Par Outstanding*
(\$ Mil., As of Dec. 31, 2006)

	Ambac	AGL**	CIFG	FGIC	FSA	MBIA	RAA	SCA
RMBS: Subprime	26,890	5,104	2,486	10,960	9,648	7,265	795	3,071
ABS-CDO	20,452	3,634	9,059	6,079	385	18,967	1,549	9,468
Grand Total	47,342	8,737	11,545	17,038	10,032	26,232	2,344	12,540

*Based on Fitch's sector classifications; may not exactly correspond to company presentations. **Asset-backed securities (ABS) – collateralized debt obligations (CDO) exposure for AGL includes \$3,000 that is treated by the company as residential mortgage-backed securities. Ambac – Ambac Assurance Corp. AGL – Consolidated Assured Guaranty Corp. and Assured Guaranty Re Ltd. CIFG – CIFG Guaranty. FGIC – Financial Guaranty Insurance Company. FSA – Financial Security Assurance Inc. MBIA – MBIA Insurance Corp. Radian – Radian Asset Assurance Inc. SCA – Consolidated XLCA and XLFA. Note: Numbers may not add due to rounding. Source: Company portfolio data feeds.

Appendix IV — Stressed RMBS: Subprime and ABS-CDO Gross Par Outstanding*
(\$ Mil., As of Dec. 31, 2006)

	Ambac	AGL**	CIFG	FGIC	FSA	MBIA	RAA	SCA
RMBS: Subprime	5,890	2,615	1,750	5,930	2,777	3,230	138	469
ABS-CDO	20,419	3,033	9,059	6,079	300	15,551	769	8,429
Grand Total	25,409	5,648	10,808	12,008	3,331	16,800	808	8,699

*Based on Fitch's sector classifications; may not exactly correspond to company presentations. **Asset-backed securities (ABS) – collateralized debt obligations (CDO) exposure for AGL includes \$3,000 that is treated by the company as residential mortgage-backed securities. Ambac – Ambac Assurance Corp. AGL – Consolidated Assured Guaranty Corp. and Assured Guaranty Re Ltd. CIFG – CIFG Guaranty. FGIC – Financial Guaranty Insurance Company. FSA – Financial Security Assurance Inc. MBIA – MBIA Insurance Corp. Radian – Radian Asset Assurance Inc. SCA – Consolidated XLCA and XLFA. Note: Numbers may not add due to rounding. Source: Company portfolio data feeds.

Appendix V — Matrix Loss Contribution
(\$ Mil., As of Dec. 31, 2006)

Rating Threshold	'AAA'	'AAA'	'AAA'	'AAA'	'AAA'	'AAA'	'AA'	'AAA'
	Ambac	AGL	CIFG	FGIC	FSA	MBIA	Radian	SCA
RMBS: Subprime	459.0	15.2	8.9	370.2	56.5	27.7	4.5	0.1
ABS-CDO	123.9	92.1	155.0	57.0	2.4	124.4	39.0	73.7
Other*	3.7	(45.5)	(21.4)	(11.3)	(30.9)	21.1	(2.3)	(30.0)
Total Incremental RCPR Impact	586.6	61.8	142.5	415.9	28.0	173.2	41.1	43.7

*The "Other" category represents the sum of the incremental loss changes contributed by the sectors that were not stressed as a part of this analysis; such changes are inherent in the process of stochastic modeling. ABS – Asset-backed securities. CDO – Collateralized debt obligations. RMBS – Residential mortgage-backed securities Ambac – Ambac Assurance Corp. AGL – Consolidated Assured Guaranty Corp. and Assured Guaranty Re Ltd. CIFG – CIFG Guaranty. FGIC – Financial Guaranty Insurance Company. FSA – Financial Security Assurance Inc. MBIA – MBIA Insurance Corp. Radian – Radian Asset Assurance Inc. SCA – Consolidated XLCA and XLFA. RCPR – Required Claims-Paying Resources.

Appendix VI — Explanation of Ratios in Appendices I and II

- (1) **Equity-Like Soft Capital** — Equity-Like Soft Capital consists of soft capital facilities, such as contingent preferred stock put facilities that are given equity credit. Reinsurance-like soft capital, such as bank lines, is treated separately under Matrix.
- (2) **Required Capital for Factor-Based Charges** — The Required Capital for Factor-Based Charges is the total required capital for factor-based charges (reduction to available capital) based on the individual company's investment portfolio, investment agreement and medium-term note (MTN) portfolio, other invested assets, and the present value of installment premiums based on its given rating threshold. The composition of each financial guarantor's investment portfolio by asset class and rating is used to determine a portfolio level mean "credit spread return" and standard deviation of this return that is used to calculate a factor charge based on its rating threshold, which then reduces the guarantor's available capital by that amount. If the company has an investment agreement and MTN portfolio (commonly including guaranteed investment contracts, or GICs), then it is determined whether the portfolio is duration matched, mismatched short (0.5–1.5 years) or mismatched long (greater than 1.5 years), with each classification carrying its own mean return and standard deviation used to determine a factor charge based on the company's rating threshold. A fixed factor charge is applied to other invested assets regardless of rating threshold. The present value of installment premiums are further discounted by $(1 - \text{the percentage of structured finance defaults})$, which varies depending on which rating threshold is appropriate and thus reduces the guarantor's claims-paying resources accordingly.
- (3) **Core Capital Adequacy Ratio (CCAR)** — The CCAR is the ACPR divided by the RCPR. It is the key ratio that measures a company's capital adequacy under a given rating threshold and provides an indication of whether a company has excess capital. If a company's CCAR exceeds 1.0x, it can meet simulated losses and business expenses based on its available capital resources.

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