

Global Criteria Report

Criteria for Structured Finance Recovery Ratings

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This criteria document defines the overarching principles for assigning Recovery Ratings (RRs) to distressed or defaulted securities across SF asset classes. Fitch will release separate reports detailing the implementation of RRs for each SF asset class.

Summary

This criteria report describes Fitch Ratings' methodology for assigning Recovery Ratings (RRs) to distressed and defaulted structured finance securities. The report harmonises the nomenclature for structured finance (SF) recovery ratings with the 'RR1'-'RR6' scale for corporate and public finance issuers. This criteria report supersedes the report "*Structured Finance Distressed Recovery Ratings*", dated 25 April 2006, which introduced the concept of 'Distressed Recoveries' (DRs).

The most significant changes in this criteria report include:

- RRs are assigned on the 'RR' scale from 'RR1' to 'RR6'. This scale is also used for RRs for corporate and public finance. Previously, SF recovery ratings were assigned on a scale of 'DR1' to 'DR6';
- RRs are assigned to distressed or defaulted securities rated 'CCC' and below. Previously, DRs were assigned to securities rated 'B-' and below;
- There is no longer a link between RRs and Fitch's credit ratings on the agency's primary letter scale. Previously, distressed credit ratings reflected expected loss based on the security's recovery prospects expressed by the DR and this rating could be higher or lower than the default credit rating;
- Fitch will issue specific reports describing the detailed implementation of RRs for each asset class;
- Fitch will release RR calculation templates for each asset class. These templates will not only provide a greater level of transparency, as regards the assumptions Fitch makes in determining RRs, but also allow investors to modify the RR calculation using their own assumptions.

RRs are designed to provide a forward-looking estimate of recoveries on currently distressed or defaulted finance securities. Distressed securities are defined as securities which face a real possibility of default at or prior to maturity. Such securities will by definition be rated 'CCC' or below.

RRs are determined on the basis of all expected future cash flows to the security in question, irrespective of whether these cash flows derive from scheduled payments or liquidation proceeds and whether the source is interest or principal, taking into account Fitch's expectations regarding future losses and the time value of money. These cash flows are compared to the outstanding principal balance of the rated security to derive a recovery value.

RRs will be issued on a scale of 'RR1' (highest) to 'RR6' (lowest) to denote the range of recovery prospects for a currently distressed or defaulted security.¹ These distressed recoveries will be issued in addition to long-term credit ratings (LTCRs) for SF securities and will be surveilled on an ongoing basis.

¹ See page 2 for definitions of the rating classes 'RR1' through 'RR6'

RRs are assigned to distressed SF securities and complement LS ratings, which are assigned to performing securities.

Highlights of the recovery ratings criteria include:

- RRs are distinct from loss-severity (LS) ratings, which are assigned to performing SF securities rated in the 'B' category or higher;
- RRs represent forward-looking recovery expectations, taking into account Fitch's expectations as regards all principal and interest cash flows over the remaining life of the transaction;
- RRs are calculated under Fitch's expectation of future losses for the relevant security;
- RRs account for the time value of money at a fixed discount rate of 10%²;
- As with other ratings, RRs are subject to ongoing surveillance;
- Analysts may apply discounted cash flow analysis and qualitative judgment in the determination and updating of RRs. Where qualitative judgment is relied on to a significant extent, this will be disclosed in Fitch's rating communication.

Table 1: Recovery Ratings Definitions

RR1	Outstanding recovery prospects given default 'RR1'-rated securities have characteristics consistent with securities historically recovering 91%-100% of current principal and related interest.
RR2	Superior recovery prospects given default 'RR2'-rated securities have characteristics consistent with securities historically recovering 71%-90% of current principal and related interest.
RR3	Good recovery prospects given default 'RR3'-rated securities have characteristics consistent with securities historically recovering 51%-70% of current principal and related interest.
RR4	Average recovery prospects given default 'RR4'-rated securities have characteristics consistent with securities historically recovering 31%-50% of current principal and related interest.
RR5	Below average recovery prospects given default 'RR5'-rated securities have characteristics consistent with securities historically recovering 11%-30% of current principal and related interest.
RR6	Poor recovery prospects given default 'RR6'-rated securities have characteristics consistent with securities historically recovering 0%-10% of current principal and related interest.

Please refer to www.fitchratings.com for Fitch's rating definitions

Recovery ratings reflect assumptions about relative recovery expectations, rather than precise estimates. Fitch will assign recovery ratings based on the bands shown above; actual recoveries for a given security may deviate materially from the indications or historical averages

Source: Fitch

When issuing RRs, Fitch will disclose supplementary information about the components behind the agency's recovery rate expectations.

Information Disclosure

Fitch will disclose additional information when reporting RRs. Fitch believes that improved transparency is beneficial and allows market participants to better evaluate recovery rate estimates using their own assumptions. Each asset class will define a reporting template and the exact information reported may vary by asset class. The reports will in general contain the information shown below:

² The discount rate will be reviewed at least annually and may be updated

Table 2: Recovery Ratings Reporting

(Example in brackets)

Name of security and rating (Woodland Trust 2009-1 class A1, rated 'CC')
Recovery rating ('RR4')
Security principal balance as of last reporting date (USD20m)
Present value of principal recoveries (USD8m received at maturity)
Present value of expected interest payments (USD2m received over eight payment periods)
Total present value of discounted recoveries (USD10m)
Sum of undiscounted recoveries (USD13m)

Note: present value calculations are undertaken using a constant discount rate of 10% per annum. The RR is based on discounted values. The security principal balance includes capitalised interest of USD1m
Source: Fitch

Definition of a Distressed SF Security

RRs are assigned to distressed securities. Fitch recognises there are many ways to define distress in SF transactions. First and most obvious is a default; this can occur either as a payment default or a contractually defined default under the terms of the legal documents. Distressed transactions also include those where there has been sufficient credit deterioration to raise the possibility that the rated securities might be at risk of near-term loss of principal or interest.

RRs will be assigned to securities rated 'CCC' and below.

For the purposes of assigning RRs, Fitch defines distressed securities as those originally rated 'B' and above that are likely to default at maturity, as they can no longer withstand a nominal stress as determined by Fitch. By definition, such notes will have been downgraded to the 'CCC' category or below. Distressed securities also include those originally rated in the 'CCC' category or below. As a result, Fitch assigns RRs to all securities rated in the 'CCC' category or lower.

Should the relevant parties fail to provide Fitch with sufficient information to assign or maintain an RR on a security - for example, should reporting cease to be provided on a defaulted security - the agency will not assign an RR (or withdraw its existing recovery rating on the security, as applicable), and make a statement to this effect.

RRs will typically not be assigned to defaulted securities where the default is strictly temporary in nature and the rated notes become performing immediately after the event. One example would be in the case of a Coercive Debt Exchange, where a transaction that, under its original term, had been close to default and temporarily rated 'D', had been restructured to alleviate the situation and now carries a performing rating in the 'B' category or higher.³

Components in Determining an RR

Fitch's RRs are based on a standard calculation framework which applies across all SF asset classes. Because the securities that are being assigned RRs are distressed or defaulted and their cash flows are often subject to considerable uncertainty, the calculation framework in practice serves only as a guide and often uses broad based assumptions in order to increase transparency, minimise model risk, and promote usability. Qualitative considerations are in many cases overlaid during the committee process, or may replace a cash flow analysis entirely.

The determination of RRs is based on discounted expected future cash flows including any interest receipts.

These are the primary components in the RR calculation framework:

- current security balances and status in the transaction waterfall;
- expected future cash flows;
- expected future losses and timing of recoveries;

³ Please refer to the criteria report "Coercive Debt Exchange Criteria for Structured Finance", published 3 June 2009

- discount factors; and
- other analytical assumptions.

Asset recoveries reflect the amount and timing of any expected principal recoveries and any interest amounts that are expected to be paid to the notes.

Fitch arrives at its estimated recovery rate for the distressed notes by firstly calculating the net present value of all asset recoveries, reflecting Fitch's expectation of future defaults and recoveries (the 'expected case'). Fitch then determines the current outstanding principal balance, including capitalised interest, and divides the net present value of asset recoveries by this number to arrive at the recovery rate estimate. This recovery rate is the basis for assigning a recovery rating to the notes (see example in *Table 1* below).

Many investors revert to a total return analysis when evaluating a distressed security, regardless of the terms of the original structure. Treating all cash received by the security, whether principal or interest, as part of a recovery gives a clearer basis for comparison between distressed bonds. Fitch will therefore include interest in its evaluation, but also break the total into its component parts.

Relevant cash flows (for the purposes of assessing recovery) could be considered over a number of alternative periods. For instance, cash flows can be calculated over the life of a security (from inception through maturity), from the point that an investor purchases the security, or from the point of distress.

Investors have different time-horizons and may have bought the security at inception or at some point thereafter. Some investors are "buy and hold," others trade actively in the secondary market, and others focus exclusively on the distressed market. It is rarely possible to determine a single time period that would accurately and consistently encompass recoveries for all investors.

For these reasons, Fitch calculates RRs based on the agency's expectations of the amount and timing of all future cash flows from the point the RR is assigned.

Current Security Balances and Status in the Waterfall

The first step of the RR calculation is to determine the outstanding rated notional balance of the security. This will be obtained from the most recent trustee or servicer report and will reflect any reductions to the principal balance since closing, whether through actual amortisation or through write-downs. It should also reflect any increases in principal due to capitalised paid-in-kind (PIK) interest; however, it would not include any unpaid deferred interest balances that have accrued, if these are not capitalised as principal. The amount of senior securities which rank ahead of the security, ie its position in the transaction waterfall, will have a material impact on the amount and timing of any recoveries that can be expected from the outstanding security balance.

Expected Future Cash Flows

In order to make consistent assumptions for the relevant risk factors when determining RRs, Fitch analyses future cash flows under its current expectation of future performance for the security in question. Fitch will consider all expected future cash flows in the determination of RRs. The amount and timing of cash flows available to the distressed security will depend on the performance of the remaining impaired and performing assets in the securitisation pool.

By definition, the expected performance of a distressed or defaulted security is likely to differ materially from the expectation used when assigning the original credit rating. Fitch will continue to update its expectations as the transaction is reviewed on a periodic basis.

The example in *Table 3* below shows two securities from different transactions which both have current notional balances of USD20,000. Security A is expected to pay interest of USD100 per month for 120 months, but is expected to receive no principal at maturity (USD12,000 total cash received, or 60% of the original balance). Security B pays no interest but is expected to receive a principal payment of USD12,000 at month 120 (60% of the original balance). Security A's recovery prospects would appear inferior to those of Security B if only principal cash was considered, but would be on par with Security B when considering all cash flows.⁴

Table 3: Two Routes to Recovery - With and Without Interest (Undiscounted)

(USD)	Outstanding notional balance	Monthly interest proceeds	Months to maturity	Total interest proceeds	Expected principal recovery	Principal recovery rate ^a (%)	Total recovery rate ^b (%)
Security A	20,000	100	120	12,000	—	0	60
Security B	20,000	—	120	—	12,000	60	60

^a Principal recovery rate equals expected principal recovery divided by outstanding notional balance

^b Total recovery rate equals total expected interest proceeds plus expected principal recovery, divided by outstanding notional balance

Source: Fitch

While this is an extreme example, many SF securities allow principal proceeds to be used to pay interest (whether current or deferred) or may effectively revert to an interest-only strip (no future principal will be paid). Therefore, only considering proceeds that are classified as applicable to reduce the notional principal balance will not capture all of the cash that the holders of the security will receive, or give the investor a true picture of total recoveries.

Expected Future Losses and Timing of Recoveries

Fitch determines RRs on a forward-looking basis. RRs reflect the remaining recoveries expected to be received by the security from the point that the RR is assigned through to the security's legal final maturity.

In order for a security to become distressed (and therefore receive an RR), the SF transaction must have experienced - or be anticipated to experience - a greater level of defaults and/or delinquencies than was originally expected. Given the forward-looking nature of ratings, the deterioration of the underlying assets' credit quality will generally not be complete at the point when the security becomes distressed and an RR is assigned. In addition to realised losses and delinquencies in the securitised portfolio, the performance of the security will be affected by: the amount and timing of incremental delinquencies and defaults in the underlying portfolio; the amount and timing of realised recoveries; the principal repayment rate of performing assets; changes in interest rates; and other factors depending on the transaction.

For the purpose of assigning an RR, the amount and timing of expected future defaults will be determined according to Fitch's expectations and the conventions used in each asset class to analyse comparable securities.

Fitch will form an expectation of the level and timing of future defaults and delinquencies in the underlying portfolio. In some cases - for example, where the security is distressed due to factors other than underlying portfolio performance (for example, failure of a key counterparty to comply with its obligations) - the level of expected future defaults may be the amount that had originally been anticipated under a mild stress scenario (the original 'base case', often equivalent to a 'B' stress). In other cases, the expected loss for a distressed security will be materially higher than the original 'base case'; for example, a higher default

⁴ As shown in Table 4 below, recoveries under Security A are in fact better when giving consideration to the time value of money

RRs reflect Fitch's expectations of remaining principal and interest from the distressed security.

probability may be assigned if there is concern that the underlying assets will continue to deteriorate at a faster rate than originally indicated.

Estimating potential recoveries for a security in a distressed or post-default environment is a highly subjective process, subject to a high degree of uncertainty. Estimates of recovery amounts and their timing for currently impaired or defaulted underlying assets may be obtained from several sources: market observed prices at liquidation, third-party valuations, or Fitch internal estimates. Fitch's determination of the most appropriate asset recovery assumption may be based on: the liquidity and validity of prices in a secondary or distressed market; conventions for determinations by special servicers or third-party valuation providers; or other factors. In some cases - such as a CDO with fixed recovery rates or instruments that benefit from external credit protection - asset recoveries may be partly or fully determined by the terms of the documents governing the transaction.

An important consideration when evaluating future recoveries is the timing of cash receipts. The timing of future cash flows may be ambiguous; while some distressed securities continue to pay current cash coupon, others may defer coupon payments (ie PIK). Cash flow timing may further be affected by structural factors, such as event of default triggers, call options, or availability of credit protection. In summary, the timing of all future coupon flows and principal recoveries might be impossible to pin-point in advance with any certainty.

Discount Factors

Many market participants incorporate discounting when valuing distressed investments. However, the choice of discount is a matter of some debate.

For simplicity, recognising that the timing and magnitude of the underlying cash flows are highly uncertain, and to facilitate the comparison between securities, a fixed discount rate is used. Fitch will typically use a discount rate of 10% per annum in order to incorporate the concept of time value of money, and in recognition that the discount rate should reflect some measure of the risk of the distressed security.

The 10% discount rate used for RR calculation will be reviewed at least annually.

The discount rate used may vary depending on the asset class and the specific security. Where a rate other than 10% is used, this fact - and the rationale for it - will be made clear in Fitch's communication of the relevant RR. As recovery analysis is only undertaken from the point in time when securities are distressed or defaulted, all securities under consideration will have broadly comparable credit risk, hence there is limited justification for applying radically different discount rates. The application of a uniform rate also allows for a degree of consistency and comparability across all SF RR calculations. Fitch will review the discount rate at least annually to determine if the rate diverges from market standard rates to such a large extent as to be misleading. In such cases, Fitch will update the discount rate used for purposes of assigning RRs to ensure that it remains meaningful for the application of RRs.

Other Analytical Assumptions

Amortisation of Performing Assets

Amortisation of assets in some SF transactions may vary depending on prepayment assumptions. Fitch analyses appropriate amortisation cases for the underlying asset portfolio to determine the RR. When evaluating the cash flows from a distressed SF transaction, Fitch will combine its amortisation assumptions with the current expected case for the transaction, as determined by the rating committee.

Interest Rates

In addition to assumptions as regards future defaults, many SF transactions are affected by changes in interest rates. For the purpose of assigning an RR, Fitch's rating committee will decide on an appropriate interest rate assumption.

Calculation of the RR

Using all of the components previously listed, Fitch will calculate the stream of total cash payments due to the distressed security, from the present through to maturity. The discounted cash flow (the numerator) divided by the security balance (the denominator) equals the recovery percentage. This percentage will map to an RR on the scale from 'RR1' to 'RR6', as shown on page 2 (Table 1).

Table 4 below shows a continuation of the example in Table 3 above, this time using discounted values.

Table 4: Two Routes to Recovery - With and Without Interest (With Discounting)

(USD)	Outstanding notional balance	Monthly interest proceeds	Months to maturity	Total interest proceeds	Expected principal recovery	Principal recovery rate ^a (%)	Total recovery rate ^b (%)
Security A	20,000	100	120	7,567	—	0	38
Security B	20,000	—	120	—	4,433	22	22

^a Principal recovery rate equals expected principal recovery divided by outstanding notional balance

^b Total recovery rate equals total expected interest proceeds plus expected principal recovery, divided by outstanding notional balance

Source: Fitch

Security A:

- Current rated notional balance: USD20,000.
- Monthly interest of USD100 is expected to be paid for 120 months until maturity.
- No principal is expected to be paid.
- Present value (PV) of interest and principal cash flows discounted at 10% per annum: USD7,567.
- RR: $USD7,567 / USD20,000 = 38\%$ or 'RR4'.

Security B:

- Current rated notional balance: USD20,000.
- No interest to be paid over the 120 months remaining until maturity.
- Principal proceeds of USD12,000 are expected to be received, all in month 120.
- PV of interest and principal cash flows discounted at 10% per annum: USD4,433.
- RR: $USD4,433 / USD20,000 = 22\%$ or 'RR5'.

An RR is an indication of the rate of recovery given default on a current basis for distressed or defaulted securities.

While this formula exists to calculate RRs, it is possible that a rating committee will decide to apply qualitative adjustments to a calculated RR - or indeed apply an entirely qualitative approach - to better reflect Fitch's recovery expectations for the security or the potential uncertainty involved in predicting precise cash flows. Such a qualitative approach or such adjustments could be warranted, for example, in order to give consideration to the volatility surrounding a recovery rate (especially if the cash flows are far into the future) or to factor in the extent of future losses expected to be experienced by the remaining portfolio.

Relationship to Instrument Ratings on the 'AAA' Scale

Instrument ratings on Fitch's primary rating scale are assigned to all rated securities. The credit rating of a SF security addresses the default risk inherent in the transaction and the terms of the rated security.

There will be no direct linkage between RRs and instrument ratings on Fitch's primary ratings scale.

Many of the same key assumptions used to calculate an RR will be applied to an instrument rating (eg, future default assumptions; prepayment speeds, if applicable; interest rate assumptions; derivation of recoveries of defaulted assets). However, instrument ratings are typically based on an analysis of a wide range of potential parameter values and stress testing. By contrast, RRs are derived based on expected parameter values only.

The linkage between speculative grade bond ratings and the former DR categories used for distressed recovery analysis in the past has been discontinued. All SF bond ratings, whether at low speculative grade level or investment grade, are now assigned purely on a first-to-default-basis (first dollar of loss). RRs therefore purely provide complementary information. They no longer have any impact on the actual instrument rating.

Limitations

The limitations applicable to RRs are broadly similar to those relevant to LS-ratings and instrument ratings on the 'AAA'-scale (see "*Definitions of Ratings and Other Scales*", dated March 2009 for definitions of Fitch's ratings and a discussion of their limitations).

Furthermore, there are additional risks in projecting forward scenarios from which to derive an expected cash flow stream for distressed and defaulted securities. For example, the future cash flows are (by virtue of those securities that are distressed) unlikely to conform to defined payment schedules. Both their amount and timing may, therefore, be highly uncertain.

While Fitch maintains ongoing surveillance, the frequency of review may lag changes in recovery expectations for a security - or any changes in the notional balance of the security - from one period to the next, including through the process of write-downs and write-ups.

RRs reflect expectations of *future* payments of principal and interest and may change over time. For example, RRs may reduce over time as less future interest remains to be paid until maturity. Conversely, passage of time increases the discounted value of future (unpaid) recovery amounts, such as principal recoveries at maturity. The net impact on the RR over time may be positive, negative or neutral (see the "*Surveillance*" section below for a summary of individual factor impacts).

The simplified structural analysis required to compute RRs will not cover every permutation of the cash waterfall for a distressed transaction, especially for complex transactions. Distressed securities are often the subject of debt restructuring discussions, which frequently lead to alterations of existing structural or contractual measures upon which the RR is based. Fitch is unable to take creditor behaviour into account in its ratings, although this can have a substantial influence on any debt restructuring efforts. However, RRs do reflect Fitch's most current estimates of how such factors will influence the timing and magnitude of cash flows.

Surveillance of RRs

RRs will be assigned to all distressed and defaulted SF securities. Any changes to public RRs will be accompanied by a press release and available on Fitch's web site, www.fitchratings.com.

Fitch will continue to monitor the credit rating and recovery rating of distressed securities. The distressed credit rating and RR will be reviewed on an ongoing basis, depending on changes to the status of the transaction. For further details on individual ratings, please refer to Fitch's SMART site at www.fitchresearch.com.

RRs are subject to surveillance and will be reviewed as the agency updates its expectations about the rated instruments.

As mentioned previously, both the credit rating and the RR may change over time. RRs represent the present value of expected future cash flows; this may change with the passage of time, as cash flows are realised and - perhaps most importantly - as the expectations for future principal recoveries and coupon payments change. The RR could also change due to movement in other risk factors affecting the transaction. Isolating the likely impact of each factor, all else being equal, indicates that:

- As time passes and future cash flows draw nearer, the discounting applied to future cash flows will have a smaller impact. This in and of itself will *improve* the RR (however, the amount of available future cash flows could be less);
- Because the RR is calculated on a forward-looking basis, interest payments that have already been realised are not counted in the calculation. As time passes, the total amount of outstanding expected future interest payments will reduce. This will *weaken* the RR;
- Conversely, realised principal cash flows may amortise the outstanding note principal balance, which will lead the RR to *improve*;
- Write-downs on the security will *improve* the RR as future recoveries will be applied to a reduced principal balance;
- As more clarity emerges on future principal recoveries and the prospect for future coupon and principal payments, Fitch may increase or decrease its estimate of total expected future cash flows compared to its previous estimate. The impact on the RR could be *positive or negative*, although the RR will be more accurate; and
- Any other risk factor affecting the transaction could change cash flows, for example, interest rates or exchange rates. The impact on the RR could therefore be *positive or negative*.

In addition, it is possible that a security may recover from its distressed status. This may be due to improved creditworthiness on the performing portfolio assets, higher than expected recoveries on defaulted portfolio assets, changes in the transaction structure, or the provision of external support. If a security improves such that it is no longer considered distressed, the RR will be withdrawn and a public statement will be issued.

Differences Between Corporate and SF Application

RR methodology will differ between corporate and SF issuers for three main reasons:

- SF securities reflect default risk and not expected loss. As such, SF ratings do not incorporate notching from an IDR for recoveries. Hence, structured finance RRs have no impact on the default-based rating scale of SF securities;
- SF RR methodology is based on the discounted sum of future principal and interest payments whereas corporate RRs are based on an assessment of an issuer's going concern or liquidation value;
- SF methodology explicitly considers time to recovery, as this can vary significantly depending on the transaction structure and write-downs. This feature is not commonly seen in corporate issuance;
- SF securities will have RRs assigned only to distressed securities rated 'CCC' and lower, while corporate RRs will be assigned to both performing and defaulted corporate securities rated 'B+' and lower.

For more information, see Fitch's criteria for corporate 'RR' ratings on the agency's web site at www.fitchratings.com.

Appendix

Key Questions

How are Recovery Values Calculated for Distressed or Defaulted Assets?

Fitch will use the same methods for determining the value of distressed and defaulted assets as would be applied during a normal review of a transaction. For distressed assets, Fitch will consider the time to default and expected cash flows until default. For defaulted assets, Fitch will use a variety of methods including, but not limited to, bids observed in the market, third-party valuation services (eg, appraiser, special servicer), discussions with managers and originators, third-party pricing services and internal estimates. Also, there may be cases where the recoveries will be derived from natural amortisation. Finally, deal-specific constraints will be incorporated, such as restrictions on valuations, bids and settlements, and use of reserve accounts or other third-party enhancement.

How Does Fitch Derive the Cash Flows Used for an RR?

The cash flows will be derived from modelling the transaction, reflecting Fitch's expectations for the remainder of the transaction life. The distribution of cash will follow the waterfall that is unique to the transaction. In some instances, Fitch will make a qualitative assumption about cash flows. Any cash that is due to the distressed tranche will be considered as a recovery in that period, and the stream of recoveries will be discounted to arrive at a present value recovery rate.

Why Present Value the Cash Flows for RRs?

The RR is the result of a present value calculation of the distressed cash flows and any associated recovery. This is important because it will provide differentiation to investors between two securities recovering exactly the same amount, but over significantly different periods of time.

Why One Discount Rate?

During the implementation of RRs, Fitch discussed its potential approach with several key market participants. While all participants incorporated some form of a present value concept, the discount rate used varied widely according to the needs of the individual investor. Fitch believes that by applying one discount rate, market participants will be able to view RRs on a relative basis. The annual discount rate of 10% was chosen as a simple benchmark rate for ease of comparison across SF transactions.

Will Fitch Change the Discount Rate Over Time?

Fitch has no current plans to change the 10% benchmark discount rate for the calculation of RRs. Although Fitch does not necessarily expect the chosen benchmark rate to closely track actual rates used in the market, a change in the rate could occur if there was a material change in market interest rates or credit spreads. If, for any reason, this discount rate is changed, Fitch will issue a public notification to market participants via its public web site and specify how this change is expected to impact existing RRs.

Can the RR Change Over Time?

Yes; RRs are actively surveilled and can change for a variety of reasons, including the following:

- a change in the future expected cash flows from the remaining collateral;
- an increase or decrease in actual realised recoveries;
- changes in relative balances of a rated tranche and the underlying assets;
- material movements in interest rates;
- modifications to underlying assumptions relevant to the transaction.

What is the Difference Between Fitch's Loss Severity (LS) Ratings and RRs?

LS ratings differ from RRs as LS ratings are assigned to performing securities rated

in the 'B' category or higher, while RRs are assigned to distressed or defaulted securities rated 'CCC' or lower. LS ratings provide an assessment of the relative loss severity of an individual tranche within a structured finance transaction. RRs are linked to an expected recovery percentage for the security in the event that the tranche experiences a default.

Once a Security is Assigned an RR, Will it Always Have an RR, Even if the Situation Improves Dramatically?

If the instrument rating on the 'AAA' scale is raised above the 'CCC' category, the RR will typically be withdrawn and replaced by an LS rating. A security will have either an LS rating or an RR at any point in time - it will not have both.

How Will Fitch Calculate the Denominator for RRs?

Fitch will use the trustee reported outstanding balance. That may include decreases in the denominator due to amortisation or write-downs, or increases due to write-ups or realised recoveries (where appropriate) or PIK interest.

What if PIK Interest is Deferred and Not Capitalised?

In such cases, Fitch would use the trustee reported outstanding principal balance (not including PIK interest) as the denominator.

Are All Securities Rated 'CCC' or Below Considered Distressed?

Definitions at the 'CCC' level and below note that default is either a real possibility, inevitable, or imminent. At the higher end of this range - 'CCC' - the bonds may still be performing, and thus not necessarily viewed by the market place as formally distressed. Fitch nonetheless believes this is the most appropriate category at which to introduce RRs, in line with its rating definitions.

How Does Fitch Determine the Level of Stress on the Future Cash Flows?

Fitch uses the expected case for the remainder of the transaction's life. Each transaction will be viewed individually however, and it is possible that different expectations may be applied to different transactions.

Why Only Use One Scenario (ie, Interest Rates, Base Prepayments) When Fitch May Use Multiple Scenarios to Rate a Security Initially?

The RR is meant to estimate a band of possible expected recovery rates and is not meant to be an exact measure or provide pricing guidelines for the distressed tranche. In addition, it is not intended to reflect the same rating stresses which would have been incorporated into the original rating analysis. In order to create an RR that is a meaningful representation of the agency's expectations and can be easily described to the market, Fitch has chosen to simplify its assumptions.

Are SF RRs and Other Instrument Ratings Tied Together?

SF RRs and instrument ratings on the 'AAA' scale are not linked. Previously, a link was created between the rating on the 'AAA' scale of a distressed SF security and the level of DR assigned. With the revision of low speculative grade SF ratings to focus exclusively on default, this linkage no longer exists.

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