

Residential Mortgages
EMEA
Criteria Report

EMEA RMBS Surveillance Criteria

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Related Research

- [Dutch Residential Mortgage Default Model Criteria \(February 2009\)](#)
- [UK Residential Mortgage Default Criteria \(February 2008\)](#)
- [Spanish Residential Mortgage Default Model Criteria \(December 2007\)](#)
- [Greek RMBS Rating Criteria \(December 2006\)](#)
- [Irish Residential Mortgage Default Model \(March 2006\)](#)
- [Portuguese Residential Mortgage Default Model \(December 2005\)](#)
- [Italian Residential Mortgage Default Model II \(November 2005\)](#)
- [Belgian Residential Mortgage Default Model \(May 2005\)](#)
- [German Residential Mortgage Default Model \(December 2004\)](#)
- [French RMBS Default Model \(May 2004\)](#)

Summary

This report describes the process by which rated classes of pass-through Europe, Middle East and Africa (EMEA) RMBS transactions are monitored and analysed for potential rating actions by Fitch Ratings. This methodology will be applied to pass-through transactions of both prime and non-conforming residential mortgage loans for all countries in the EMEA region. The surveillance process involves a number of quantitative and qualitative functions to assess the performance of rated tranches including:

- monitoring pool level performance indicators;
- comparing current credit enhancement levels against a stressed loss assumption;
- assessing the impact of market developments on the performance of transactions; and
- loan-by-loan analysis.

Every transaction is monitored on a continuous basis following the receipt of the latest investor reports. All rating actions are reviewed using a committee process and a public rating action is taken on all transactions usually once each year. Rating actions for some transactions occur more frequently, particularly if performance of the underlying pool exhibits rapid deterioration. Surveillance data for all public transactions is available to subscribers via www.fitchresearch.com.

This methodology is not a substitute, but used in conjunction with the published RMBS criteria (see left for main EMEA jurisdictions highlighted in the Related Research box); however, assumptions will evolve from the original analysis, if needed, based upon actual or expected performance to date.

This report is specific to surveillance affecting collateral performance and does not address other factors that affect the ratings such as third party hedge providers, account banks, guarantors, or changes in law in particular jurisdictions. Many of these other factors are addressed in separate criteria reports issued by Fitch.

Key Rating Drivers

It is usually a combination of factors that leads to a rating action on a particular tranche rather than a single factor. There are however key factors that can result in a rating action, or signal that this is likely if other factors indicate the same direction.

Upgrades

Credit Enhancement Growth

The largest driver for any positive rating action is a build-up in credit enhancement since the original rating was assigned. The majority of EMEA RMBS transactions are pass-through transactions, using a sequential pay down of the notes, at least for the early life of the transaction. This allows credit enhancement to build and is expected as part of the initial rating process. For a portfolio that performs well, the upgrade of tranches is likely over time, as long as the performance of the underlying pool does not deteriorate through negative selection to outweigh the build up in credit enhancement.

Collateral Performance

The performance of the underlying collateral is a key driver in any rating action decision. A transaction that is experiencing substantially better performance than the agency's initial expectations is likely to see positive rating actions, especially in combination with a build-up in credit enhancement as described above. Examples of good performance would be low arrears or default rates, and/or low loss severity on defaulted loans.

Collateral Characteristics

A less common change to a transaction that could lead to an upgrade would be an improvement in the underlying collateral characteristics. This could occur as the transaction prepays, with the remaining loans having better collateral characteristics such as a lower weighted-average loan-to-value ratio (LTV) or, for revolving pools, the collateral added to the portfolio could be of a better quality with lower credit risk, therefore reducing the default probability. In reality this type of change to the underlying portfolio tends to be minimal, and would usually not be significant enough to result in a change in rating.

Downgrades

Utilisation of First Loss Piece

Draws from a cash reserve fund, or the utilisation of cash from a first loss threshold, indicate that a transaction has insufficient revenue funds in a given period to meet payments due on the notes. The reserve fund is usually in place to provide support in these situations and therefore one-off or small drawings are not likely to result in a downgrade of the notes. Fitch analyses whether it is expected that these drawings will continue into the future, or if they are an indicator of other problems within the transaction or underlying collateral.

High and Rapid Default Rates

As part of the agency's initial analysis, transactions are stressed under a variety of default scenarios. These are based on country-specific expectations for a number of factors such as, inter alia, default rates, prepayment rates and the timing of recoveries. The expectation for default timing is based on either the typical foreclosure period, or for transactions that write off delinquent loans, the timing at which loans are defined as defaulted.

Transactions with loan defaults higher than the agency's initial expectations will have lower cash flows early in their life, although it could result in earlier recoveries. If defaults are significant, it will cause a negative rating action as the transaction will be under significant stress early on, from which it may not recover.

Pool Quality Deterioration

The composition of the underlying pool of mortgages can change over time, and have a negative impact. Typically loans that fall into arrears will find refinancing opportunities harder to come by, and therefore as other loans in the pool prepay the pool becomes adversely selected. In addition to being in arrears, the loans remaining in the pool are often those with worse collateral or loan characteristics, such as high LTV products or borrowers with adverse credit histories. These borrowers and loan types have a higher default probability and therefore the pool as a whole has a higher risk. Fitch accounts for an element of adverse selection in its original rating process, and also expects that growth in credit enhancement from prepayment will balance out the increased credit risk of the pool. However, the pool may see more adverse selection than expected, and in addition may be affected by wider market behaviour that exacerbates adverse selection, leading to insufficient support to maintain the original ratings. Fitch compares the pool characteristics at close with the current pool to assess any potential deterioration.

Surveillance Rating Process

To monitor the ratings drivers listed above, and to assess the continued appropriateness of current ratings of a transaction, the agency uses a selection of tools. The first step is monitoring the data received at each payment date and assessing the impact of any changes to collateral performance.

Credit Cover Multiple

Changes to collateral performance will first be assessed using Fitch's Credit Cover Multiple (CCM) methodology described in this report. The CCM methodology provides an indicator of the performance of a transaction by comparing current credit enhancement to expected loss. The CCM is a tranche level indicator that reflects the stressed loss for each tranche, based on the current rating category, compared to the available credit enhancement for the tranche. The stressed loss (of which the equation is provided in the following table) is a function of the loans in arrears or possession multiplied by an expected default probability and loss severity at each rating level plus a modified credit enhancement applicable to the performing loans in the pool. This modified credit enhancement is generally similar to original credit enhancement at transaction closing, adjusted by a seasoning adjustment (also called a performance factor), which allows for transaction aging and/or losses that may have already occurred. The resulting stressed loss at the relevant rating level is compared to current credit enhancement to determine if the pool could absorb the expected pool loss at this given point in time.

CCM = Credit Enhancement (%) / Stressed Loss (%)

Calculation of Credit Enhancement

Credit Enhancement = Aggregate Balance Of Subordinate Notes + Reserve Fund Balance + Overcollateralisation/Total Note Balance

Calculation of Stressed Loss

Stressed Loss = Σ Stressed Loss (Current Loans), (two- to three-month Delinquent Loans), (three month+ Delinquent Loans), (Current Possessions)

Where

Stressed Loss (Current Loans) = Current Loan% * Initial Credit Enhancement * Performance Factor;

Stressed Loss (2-3m) = 2-3m% * $DF_{2-3\alpha\beta}$ * $LS_{\alpha\beta}$;

Stressed Loss (3m+) = 3m+% * $DF_{3m+\alpha\beta}$ * $LS_{\alpha\beta}$;

Stressed Loss (Possessions) = Current Possessions% * $LS_{\alpha\beta}$

And

The performance factor is the performance factor at ϕ months since deal close (or for revolving pools since the end of the revolving period).

$DF_{<2-3\alpha\beta}$ is the default frequency assigned by Fitch for loans that are delinquent by two to three months for rating category α and based on a deal WAOLTV of β ;

$DF_{3m+\alpha\beta}$ is the default frequency assigned by Fitch for loans that are delinquent by more than three months for rating category α and based on a deal WAOLTV of β ;

$LS_{\alpha\beta}$ is the greater of original loss severity assigned to each transaction at each rating category, or the loss severity experienced by the transaction in that period;

Initial credit enhancement is the credit enhancement required for that rating category at closing (calculated with a fully funded reserve fund).

A full worked example can be found in *Appendix 2*.

It is important to note that the CCM assumes all losses occur immediately, whereas in reality these will occur over a period of time. A CCM below 1.00 does not therefore necessarily mean the tranche in question will be downgraded, it is an early indicator to flag the need for additional monitoring. Further analysis is needed to assess whether the tranche has adequate support to maintain its current rating when all factors are considered. The most basic of these additional factors would be available excess spread to cover losses, particularly in the near term, which is not accounted for in the CCM and would be assessed by supplementary cash flow modelling where appropriate.

A CCM above 1.00 indicates that the tranche can absorb more loss than currently expected at each rating scenario. If the CCM continues to improve it will be analysed for upgrade. However, other factors, such as the transaction structure and general economic conditions, must be considered, before an upgrade rating action would be utilised. Fitch has undertaken testing to determine levels at which upgrades can comfortably occur. Based on this testing, an individual tranche would not be assessed for upgrade unless the CCM is above 1.25. However, as stated earlier, other factors, such as wider market performance, are considered by the rating committee, and higher CCM values, in and of themselves, may not be sufficient to cause an automatic upgrade.

Cash Flow Analysis

Fitch updates its initial cash flow models to obtain expectations of the transaction's performance from its current status. For most transactions, the cash flow of the deal will have changed significantly from closing, mainly due to the level of delinquency and defaults in the pool. This usually requires a number of amendments to the cash flow assumptions made by Fitch (as compared to the original rating) to ensure that the output is an accurate reflection of actual performance.

Producing an updated cash flow output provides three key advantages for surveillance purposes:

- It helps assess current ratings against more realistic stress scenarios that happen over a period of time.
- It provides short- and medium-term expectations for expected reserve fund draws.
- It helps assess the level and timing of excess spread within the transaction taking into account potential changes in prepayment, reduction in loan margin and the impact of hedging or other structural features.

However, cash flow analysis has limitations. Although it addresses potential loss, it is more limited in assessing potential downgrades at a point in time. It is particularly useful when portfolio performance significantly wavers from original expectations in either a positive or negative way.

In many instances (although in the current economic environment this is decreasing), differences between actual performance and expected performance are minor. In these instances, the CCM methodology is more useful and is better positioned to handle the potential rating movements.

Using the CCM Methodology for Rating Actions

As described above, the CCM provides an indicator of the loss coverage of each tranche. However, the CCM, in and of itself, is a point in time analysis, which does not provide credit for default timing, excess spread, prepayments or the point the transaction is in its life cycle. By itself, it is useful for certain actions, but for others, the analysis is enhanced to provide a forward looking view of the development of the CCM over time. These will be described in the following paragraphs.

Upgrades

The CCM is used in a straightforward manner to assess upgrades. If a tranche has a CCM above 1.00 then it has adequate cover to prevent a loss on that tranche under a stressed scenario attached to the relevant rating category. To allow for a reasonable level of fluctuations in performance, a tranche would not usually be assessed for upgrade until performance continues to show a positive trend in the CCM value above 1.25. When this trend is established, the agency will assess the CCM value at higher rating categories. At a higher rating category, the CCM value will fall (see the example below) because more conservative assumptions are made for default probabilities and loss severities. The CCM will also be projected forward over the next 18 months, based on an expected scenario to ensure that an adequate value is maintained. This projection is then also used in assigning the Outlook for the tranche, as a continued increase in the CCM would likely suggest a further upgrade is possible over the next two years.

CCM Upgrade Example

Prime Transaction				
Seasoning		36 Months		
Performance Factor (%)		75		
Current Credit Enhancement for 'A' Tranche (%)		10		
Rating (%)		A	AA	AAA
Initial Required Credit Enhancement		5.00	8.00	10.00
WALS (Deal Specific)		10.00	12.00	15.00
WADP 2-3 Month Arrears		70.00	80.00	90.00
WADP >3 Month Arrears		90.00	95.00	100.00
WADP Current Possessions		100.00	100.00	100.00
Assessment of 'A' tranche for upgrade				
Current Rating		A	A	A
Proposed Rating		A	AA	AAA
Initial CE * Performance Factor (%)		3.75	6.00	7.50
Performing Balance (%)	98.00	3.68	5.88	7.35
Delinquent 2-3 Months (%)	0.50	0.04	0.05	0.07
Delinquent >3 Months (%)	1.50	0.14	0.17	0.23
Current Possessions (%)	0.50	0.05	0.06	0.08
Stressed Loss (%)		3.90	6.16	7.72
Current CE * CPR (%)		11.00	11.00	11.00
Credit Cover Multiple		2.82	1.79	1.43

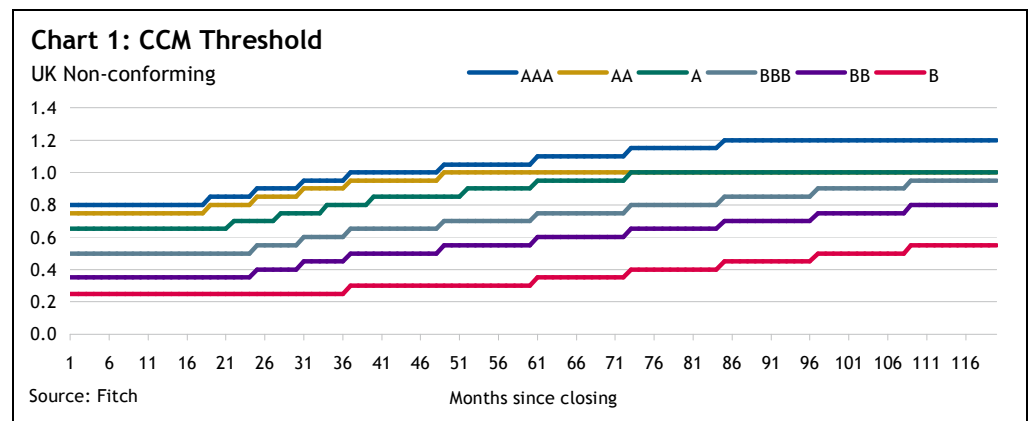
WALS - Weighted-average loss severity
WADP - Weighted-average default probability
CE - Credit enhancement
CPR - Constant prepayment rate
Source: Fitch

If the tranche maintains a suitable CCM score, Fitch will analyse other variables in the deal, such as collateral composition, loan performance and structural features, to ensure that these also support an upgrade to the rating. The CCM is not the only factor taken into consideration. For example, a deal may have de-levered, leading to an increase in credit enhancement, but at the same time seen significant adverse selection. Although the CCM indicates an upgrade is possible, the potential for further defaults has increased, and therefore the growth in credit enhancement from the original level, which was based on the complete pool, is not enough to provide support for an upgrade.

In some cases, a reserve fund may step down in the future, based upon certain triggers, and will cause a reduction in credit support that has built up over time. Whether such step-downs are expected to occur would therefore be taken into consideration when assessing any upgrade.

Downgrades

The CCM figure will often be below 1.00 during the life of the transaction, due to it not taking account of default and loss timing and the benefit of excess revenue and prepayments over time. As a result, Fitch has created a database of historical CCMs to use as a benchmark for comparison. Whilst this database does not include transactions that have failed (as none have), the benchmarks are viewed as minimum thresholds that current transactions must exceed to maintain their rating. Any breach (and in some cases near breach) of such line would mean almost certain downgrade. An example of target thresholds is exhibited in the following chart labelled *CCM Threshold*. During the life of the transaction, Fitch compares the CCM value of a given tranche against a minimum threshold for each rating at different points in time. The thresholds, which are based on a large database of historical transactions, incorporate observed pool characteristics such as the expected build up in arrears of a transaction, and prepayments. Over time, the threshold for each rating increases, and should eventually at least be at, or near, 1.0 by transaction maturity. For clarity, a tranche will not need to be at a CCM of 1.0 at maturity if sufficient excess spread exists to cover the shortfall.



If the rating of a specific tranche approaches or breaches the threshold, it is considered for downgrade.

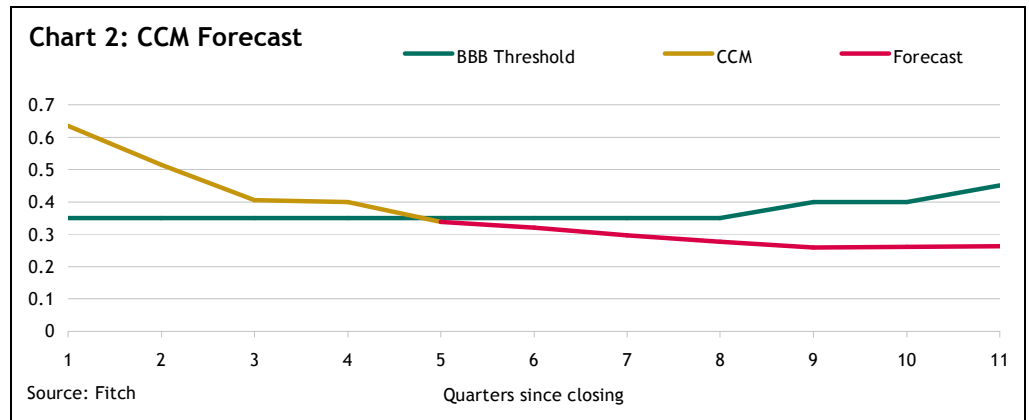
Forward-Looking Adjustments

Up to this point, the CCM has been used to judge historical and current performance, but one should also consider expected future performance. To ensure that rating actions are forward looking, a projection of future CCMs is also made. This projection is made over an 18-month period and is very useful in providing early rating actions and changes to Outlooks.

To project the CCM forward, assumptions are made for the following parts:

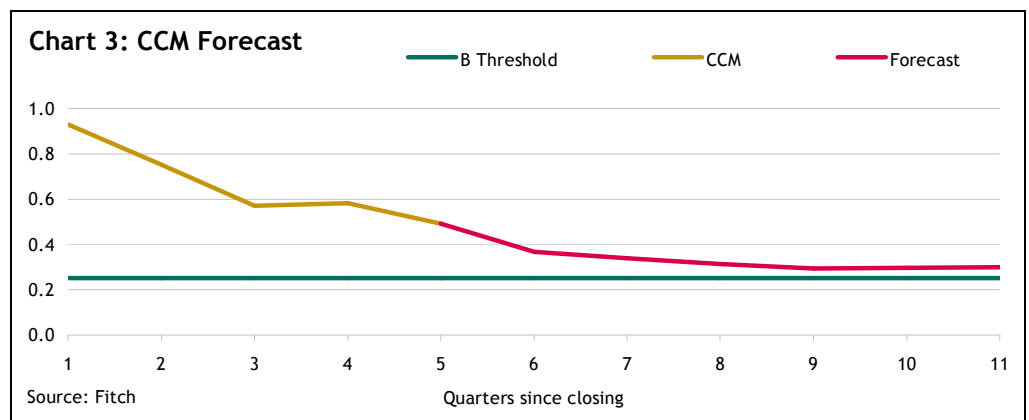
- arrears (usually two to three months, and greater than three months);
- current possessions;
- constant prepayment rates (CPR);
- loss severity (usually the greater of Fitch's original expectations, current period actual, or Fitch's expectations of future loss); and
- reserve fund draws.

The rating committee assesses portfolio performance to date and expected future performance and agrees to a set of variable assumptions to utilise for the projection. These variables can be increased or decreased over time depending on the committee's view of performance trends. Typically the projection will utilise other transactions as benchmarks, as well as wider market developments. These projections are then used to plot a forward-looking CCM curve, which can be compared to a rating threshold line (as highlighted in the chart below).



In the example above, the CCM has moved below the threshold line as of the last interest payment date (IPD) (period '5' on the gold line). The forecast (red line) for the transaction is for rising arrears levels, increasing loss severities and a low CPR. The combination of these factors means that the CCM continues to fall before stabilising (at period '9'). This tranche would be downgraded.

The next step is to determine the severity of the downgrade. CCM thresholds are rating category specific and, in this case, the chart above is comparing the 'BBB' rated notes' projected curve (the gold and red line) with a 'BBB' threshold (the green line). To determine the severity of the downgrade, the projected curve (the gold and red line) is compared to CCM threshold curves of lower rating categories. The new rating category chosen for the tranche is the one that passes (or remains above the CCM threshold curve) for at least the next year. If the projected curve remains for more than a year above the chosen CCM threshold, but continues to decline or crosses the threshold in a later period (more than one year hence), that tranche would usually be placed on Negative Outlook. Continuing the example, the next chart plots the original projected curve of this tranche onto a 'B' threshold. In this case, the projected curve remains above the 'B' threshold over the next six periods (quarters in this case), thus it would be downgraded to 'B', most likely with a Stable Outlook (because the projected line does not breach the threshold line over the next 18 months).



However, the tranche could be placed on Negative Outlook given its closeness to the threshold. For clarity, the thresholds were created using empirical information from a relatively benign environment, thus the threshold line is deemed a minimum requirement. The transaction would then be monitored in each period to see if the actual performance is in line with the forecast, and whether other rating actions should be taken.

Pool Level Performance Indicators

Arrears

A key indicator for the performance of an RMBS transaction is the volume of loans currently in arrears. Loans in arrears have already demonstrated an inability to meet their regular loan payment and therefore have a higher tendency to ultimately default. The “roll rate” (defined as the proportion of loans moving from arrears to default) is, however, dependent on a number of factors and Fitch uses different assumptions for each product type and country.

As part of the surveillance process, the current level and trend of arrears is monitored at each reporting date to assess the performance of the pool. A comparison is made between the level of arrears and the expectation of arrears for a transaction of that type at a similar level of seasoning. Fitch produces a number of arrears indices covering each major EMEA jurisdiction (see “*Around the Houses*” quarterly reports) that provide a benchmark against which transactions can be measured - although, as with any index, no transaction will perfectly fit the index and therefore when assessing the performance of a deal, it is important to compare against similar types of transaction (e.g. by originator, product type, vintage) as well as the index as a whole.

Foreclosed Loans

Although arrears are a leading indicator of potential losses, a more absolute statistic is the level of foreclosed loans in the portfolio that have not been sold (also called loans in possession). Obviously these loans are always assumed to have a 100% default probability. Because these loans are awaiting sale, a loss expectation is applied to each loan and the timing of that loss can be more accurately predicted than for loans that are in arrears. Fitch makes an estimate based on the historical length of time that loans for that particular pool have taken to be sold following foreclosure (adjusted, of course, for future expectations).

Losses

The level of losses experienced by any RMBS transaction can have a direct impact on the notes of a transaction and therefore are monitored closely. Losses are typically covered using available excess spread within a transaction, and therefore while losses are lower than excess spread the transaction maintains its current level of credit enhancement and is therefore less susceptible to negative rating action. Losses greater than excess spread in a given period will lead to a reserve fund draw, utilisation of a first loss piece or reduction in overcollateralisation.

The reporting of actual losses on foreclosed loans can be inconsistent across EMEA RMBS transactions, and poses additional challenges to the surveillance process. In instances where inconsistencies are deemed material, or where reporting is unclear, Fitch requests further data and/or adjusts its assumptions to account for these features.

Loss Severity

The loss severity on sold foreclosures can vary over time depending on a number of factors, such as the type of property, the length of the foreclosure process and the general housing market situation. Fitch takes account of the different factors affecting loss severity and also factors in expectations of future developments to house prices. The reporting of loss severity figures is most rigorous for UK non-conforming transactions, and many issuers in this sub-sector are also now making loan-by-loan level loss data available on their reporting websites, allowing investors to analyse the potential drivers of losses themselves.

Rating Actions

All rating actions are taken by committee consensus. The committees are chaired by a Fitch senior director or higher. Current performance data and Fitch criteria are used to evaluate the pools and credit assessments. As such, the updated analysis reflects current levels for comparable transactions with similar characteristics and stressed performance indicators.

Fitch expects its ratings to withstand some level of fluctuation in underlying collateral performance and rating actions are taken only when a measurable change in performance expectations since issuance has occurred.

Ratings can be placed on Rating Watch to notify investors of a reasonable probability of a rating change, as well as the likely direction of such change. Under Rating Watch, ratings are designated as Positive, indicating a potential upgrade; Negative, for a potential downgrade; or Evolving, if ratings can be raised, lowered, or maintained. Rating Watch is typically resolved over a relatively short period (up to six months).

Rating Outlooks

Rating Outlooks represent the direction (Positive, Negative, Stable or Evolving) the ratings are likely to move over the next one- to two- year period. Rating Outlooks do not indicate with absolute certainty that a rating action will occur, but instead indicate Fitch's expectation for the tranche. Rating Outlooks are based on the agency's expectation for future performance and contain more subjective elements than long-term rating actions (Upgrades, Downgrades and Affirmations).

Tranches do not necessarily need to be assigned a corresponding Outlook prior to rating action, in particular where changes in performance trends are sudden or dramatic. Therefore, prior to downgrade, a tranche will not necessarily have a negative Rating Outlook.

Appendix 1 - Credit Cover Multiple Tables

Performance Factors

Months since close	Asset Type (%)	
	Prime	Non-conforming
0	100	100
6	100	100
12	98	96
18	96	92
24	90	89
30	84	87
36	75	86
42	67	84
48	60	83
54	53	82
60	48	81
66	44	80
72	40	79
78	40	79

Note: The performance factor for non-conforming assets is higher (more conservative) as losses tend to be realised later in the life of transactions; furthermore, the higher level of arrears means less credit is given to account for higher potential defaults.

Source: Fitch

Default Probability - Loans in arrears by Two to Three Months

	Asset Type (%)	
	Prime	Non-conforming
AAA	90	70
AA	80	62
A	70	54
BBB	60	46
BB	50	38
B	40	30

Note: Non-conforming loans have historically demonstrated a greater tendency to revert to performing after having been in arrears than prime loans, thus, default probability is lower for non-conforming loans.

Source: Fitch

Default Probability - Loans in arrears by Three or more Months

	Asset Type (%)	
	Prime	Non-conforming
AAA	100	100
AA	95	93
A	90	86
BBB	85	79
BB	80	72
B	75	65

Note: Non-conforming loans have historically demonstrated a greater tendency to revert to performing after having been in arrears than prime loans, thus, default probability is lower for non-conforming loans

Source: Fitch

Appendix 2 – CCM Example

The example below is for a Prime transaction:

Transaction Data

Current Tranche Rating = A

Original WALS for 'A' = 12%

Seasoning 12 Months

Performance Factor = 75%

Collateral Data

Performing Balance = 98%

2-3 Months in Arrears = 0.5%

>3 Months in Arrears = 1.5%

Current Possessions = 0.5%

Initial 'A' Credit Enhancement = 5%

Current Credit Enhancement = 5.50%

Stressed Loss Calculation

a) Performing Balance * (Initial Credit Enhancement * Performance Factor)

$$98\% * (5\% * 75\%) = 3.68\%$$

b) 2-3 Months in Arrears * 'A' Loss Severity * Default Probability

$$0.5\% * 12\% * 70\% = 0.04\%$$

c) >3 Months in Arrears * 'A' Loss Severity * Default Probability

$$1.5\% * 12\% * 90\% = 0.16\%$$

d) Current Possessions * 'A' Loss Severity * 100%

$$0.5\% * 12\% * 100\% = 0.06\%$$

Stressed Loss Total = a + b + c + d

$$3.68\% + 0.04\% + 0.16\% + 0.06\% = 3.94\%$$

Credit Cover Multiple

Current Credit Enhancement / Stressed Loss

$$5.50\% / 3.94\% = 1.40$$

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