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Synthetic CDO Presale Report

Chess II Ltd.

€200 Million, \$200 Million, And ¥20 Billion Floating-Rate Notes Due 2016

Analysts: Cian Chandler, London (44) 20-7176-3752, cian_chandler@standardandpoors.com; Sriran Rajan, New York (212) 438-3137, sriran_rajan@standardandpoors.com; and Derek Ding, New York (212) 438-3563, derek_ding@standardandpoors.com
 Surveillance analyst: Priti Thanki, London (44) 20-7176-3762, priti_thanki@standardandpoors.com
 Group e-mail address: StructuredFinanceEurope@standardandpoors.com

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Class	Prelim. rating*	Prelim. amount and currency	Interest	Average Life	Legal final maturity
A	AAA	€200 million	Three-month EURIBOR plus a margin	June 2013	August 2016
B	AAA	\$200 million	Three-month LIBOR plus a margin	June 2013	August 2016
C	AAA	¥20 billion	Three-month LIBOR plus a margin	June 2013	August 2016

**The rating on each class of securities is preliminary as of Aug. 8, 2006 and subject to change at any time. Final credit ratings are expected to be assigned on the closing date subject to a satisfactory review of the transaction documents and legal opinion, and completion of a corporate overview. Standard & Poor's ratings address timely interest and principal on the notes.*

Transaction Participants

Arranger	ABN AMRO Bank N.V.
Issuer	Chess II Ltd.
Credit index portfolio administrator	ABN AMRO Bank N.V.
Reserve account provider	ABN AMRO Bank N.V.
Swap counterparty	ABN AMRO Bank N.V.

Supporting Ratings

Institution/role	Rating
ABN AMRO Bank N.V. as swap counterparty and reserve account provider	AA-/Stable/A-1+

Transaction Key Features

Expected closing date	August 2006
Structure type	Synthetic debt obligation
Portfolio composition	Corporate credit indices
Purpose of transaction	Arbitrage
Portfolio management type	Rules based rebalancing
Reinvestment period (years)	10
Weighted-average maturity of assets (years)	5

Transaction Summary

Preliminary credit ratings have been assigned to the constant proportion debt obligations (CPDOs) to be issued by Chess II Ltd.

Notable Features

This is the first CPDO structure rated by Standard & Poor's that addresses the timely payment of interest and payment of principal. Previously, Standard & Poor's has rated other credit CPPI transactions that have principal protection, and CDO transactions that have timely payment of interest and principal.

For this transaction, Standard & Poor's assessed the possibility of the returns on the risky portfolio, plus the interest received on the risk-less deposit covering the full interest due on the note and principal at maturity. The analysis models the spreads on the credit indices, the default probability of constituents of these indices, the interest rate curve, and the effect of these on the returns earned through the structure.

The CPDO is a fixed-income instrument. It targets the payment of the stated coupons by taking variable leveraged exposure to a credit portfolio to generate sufficient returns to enable the coupon payments to be made.

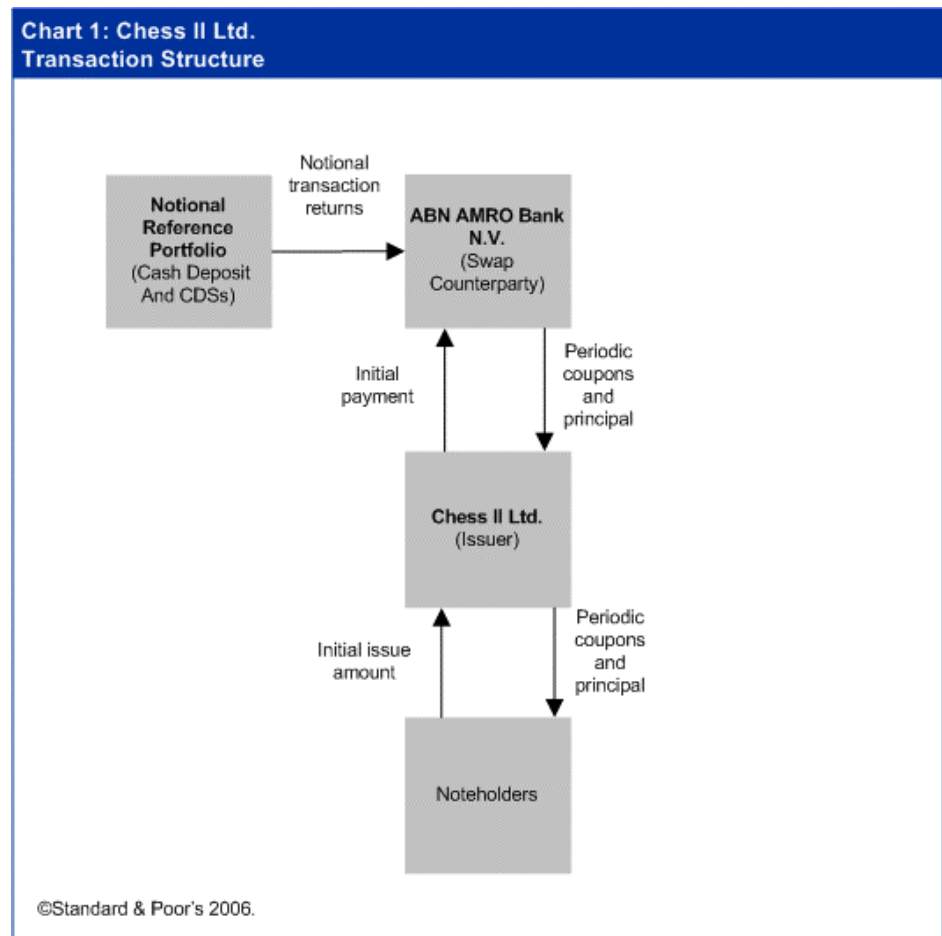
The credit portfolio comprises two credit indexes (the credit index portfolio). The risk of these indexes will be passed on to investors, potentially until August 2016, through CDSs. The leveraged exposure will change over time. The arranger will calculate this exposure using a transparent and contractually agreed dynamic leverage control formula.

In addition, CPDO differs from a standard single-tranche synthetic CDO in the following two ways:

- Under a standard single-tranche synthetic CDO, leverage is achieved by selling protection only on a specified tranche of a portfolio's theoretical capital structure. Under the CPDO, protection will be sold on the full theoretical capital structure of the portfolio, on a non-tranched basis. In other words, investors will be exposed to the full loss risk on the index portfolios subject to a maximum loss equal to their investment. Mark-to-market gains, or losses on the sold protection, do not depend on correlation, as the protection is sold on a non-tranched basis. However, leverage is created by the fact that the amount of protection sold can be a multiple of the total note notional amount.
- There is a possibility of "cashing-in" to a risk-free coupon-paying bond before maturity. This would mean that credit risk is not taken for the full life of the note, as the credit portfolio will be unwound after a cash-in event.

Mechanics Of The Structure

Under a swap agreement, the proceeds of the notes will be deposited with ABN AMRO Bank N.V. (AA-/Stable/A-1+). At the same time, CDS protection is sold on the credit-index portfolio (see chart 1).



The total notional amount of protection sold on the credit index portfolio will be such that the present value of the expected income from the credit index portfolio will cover sufficiently the difference between: (i) the present value of the coupons and the principal due under the note, and (ii) the net asset value (NAV) of the note.

The total notional amount is referred to as the target portfolio size. The NAV of the notes is calculated as the sum of the deposit value and the mark-to-market of the credit-index portfolio.

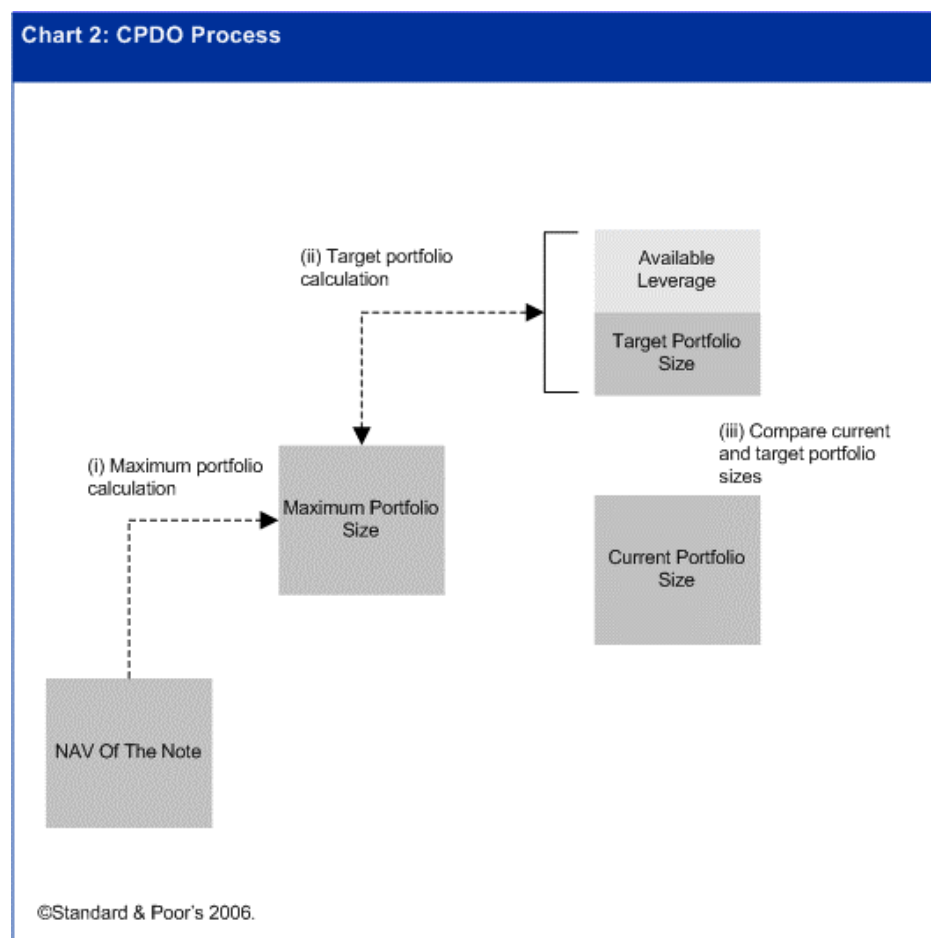
In addition, the target credit portfolio size has certain maximum size constraints. If the actual credit portfolio size differs from the target credit portfolio size by more than 25%, then the actual credit portfolio size is adjusted to equal the target credit portfolio size, subject to the maximum size constraints.

In other words, the CPDO uses only the leverage it needs to make the scheduled principal and interest payments. If the NAV increases, the target portfolio size will generally decrease as the portfolio needs to generate less income to meet coupon and principal payments. This mechanic constitutes the dynamic leverage control formula.

Once the current note NAV equals the present value of the payments under the note, the credit-index portfolio will be unwound and no further credit exposure will be taken (a cash-in event). If this occurs, all future payments due under the notes will be made, and no more exposure to a credit portfolio will be taken.

Conversely, if the current note NAV is equal to or lower than 10% of par, the credit-index portfolio will be unwound and no further credit exposure will be taken (a cash-out event).

If this occurs, all coupon payments under the note will cease and the proceeds of the cash deposit will be returned to the noteholder (see chart 2 for the CPDO process).



Strengths, Concerns, And Mitigating Factors

Strengths

- CPDOs are designed with a high likelihood of cashing-in to a risk-free investment that pays the stated coupons and principal at maturity.
- A highly rated bank will hold the note proceeds.
- When compared with a static portfolio comprised of identical underlying reference entities, rolling the indices acts as a defensive mechanism that limits negative credit migration and default risk.
- There is a high degree of transparency and liquidity in the on-the-run Dow Jones CDX, and the iTraxx European indices, which comprise the index portfolio.
- The index credit portfolio is untranched. Therefore, correlation is unnecessary for the calculation of the CPDO NAV.

Concerns

- A "cash-out" event will negatively affect interest payments and principal payment to investors.
- Credit risk and marked-to-market losses associated with the index investments and the rules governing them, may negatively affect interest payments and principal payment to investors.
- The extent of the portfolio's unfunded leverage is a source of risk.
- Forward interest rate risk movements will affect the target portfolio size and leverage adjustments.

Mitigating factors

- Standard & Poor's has analyzed the impact of the cash-out risk on interest and principal and has deemed it consistent with a 'AAA' rating.
- Standard & Poor's has analyzed the various risks associated with the transaction, particularly expected marked-to-market losses (and gains), interest rate movements, credit losses due to defaults, and has concluded that the net impact on the probability of paying timely interest and full principal is consistent with a 'AAA' rating.
- Spread widening, attended by no corresponding defaults, is beneficial to the structure.
- The structure's leverage decreases with the net present value (NPV) of future coupons promised on the structure. Consequently, the cash-in time of the structure is modeled to be less than the actual maturity of the note.

Credit Portfolio Characteristics And Management

The Credit Portfolio is initially invested in two credit indexes—the Dow Jones CDX 6 and the iTraxx Europe 5. Dow Jones and iTraxx Ltd. publish a new series of indices at six-month intervals. The index rules determine which credits are discarded and which are added. Generally, these rules seek to maximize the liquidity of the names in the indexes, and to substitute out credits that are no longer eligible credits. One aspect of eligibility in the Dow Jones CDX 6 and iTraxx Europe 5, is that all credits must be investment-grade. This serves to limit the credit risk in the transaction. Under the terms of this issuance, the transaction will be rolled out of the old and into the new indexes with the index roll dates. The marked-to-market gains or losses incurred due to this rolling feature will be deducted or added to the deposit.

Redemption Of The Notes

The notes will be redeemed at maturity using the balance of the deposit account.

General Modeling Framework

Broadly, modeling of this CPDO transaction falls into five categories: credit spread dynamics, interest rate movements, default correlation and timing, cashflow mechanics, and trading rules.

Spread dynamics

A logged "*Ornstein-Uehlenbeck*" spread process is employed to model the portfolio spread with the specifications of:

- A long-term mean (α), a mean reversion speed (κ), and volatility (δ).

This spread process represents the weighted-average spread of the pool at any given point in time. The mean reversion speed and volatility are calibrated from historical indices data. For the long-term mean, instead of applying it as a constant throughout the life of the transaction in our modeling, we use a slightly lower number for the first year because of the benign spread environment. We then increase the long-term mean at year two, and keep it constant until the maturity.

This spread determines the yield received on CDS held in the credit-risk portfolio. Referencing the duration of assets in the index and a credit DV01, spread changes translate directly into mark-to-market changes in credit-risky holdings. Naturally, spread changes also determine rebalancing events, or in extreme circumstances, cash-out events.

Interest rate movement

Standard & Poor's uses two separate interest rate processes to model the short-time rate and the full-term structure: (i) a mean reverting interest rate process used to model the short-term three-month LIBOR accrued by the cash deposit account, and (ii) a single-factor mean reverting interest rate process used to model the full-term structure of the interest rate movement, and applied in the present value calculation. This "parametization" is consistent with Standard & Poor's interest rate criteria.

Default correlation and timing

The default times are generated by Standard & Poor's CDO Evaluator, and loss paths are computed. Recovery rates on any default are taken to be the average portfolio recovery at trade inception.

Depending on the notional value of protection sold and size of the reserve, losses may imply rebalancings or—in more extreme scenarios—cash-out events. Correlated defaults may cause shortfalls between the NPV of future promised cash flows, and the current portfolio value that exceeds the structure's ability to rebalance.

Cash flow mechanics

The treatment of index rolls, bid-offer spread effects, running fees reflecting transaction costs, and payment of coupons are a critical component of the model.

Trading rules

The enforcement of trade rebalancing rules determines the evolution of the size of the credit portfolio. These rules are based on monetary ratios, and are therefore dependent on the cash flow mechanics outlined in "*Cash Flow Mechanics*".

Criteria Referenced

- "*CDO Spotlight: Approach To Rating Leveraged Super Senior CDO Notes*" (published on Aug. 22, 2005).
- "*CDO Spotlight: Criteria For Rating Market Value CDO Transactions*" (published on Sept. 15, 2005).
- "*Global Methodology for CDOs of Equity and CDSs*" (published on Feb. 17, 2004).
- "*Criteria for Rating Synthetic CDO Transactions/Credit Derivative Criteria*" (published on Sept. 12, 2003).
- "*Criteria Regarding Legal Opinions in the Context of CDOs*" (published on May 12, 2003).
- "*European Legal Criteria for Structured Finance Transactions*" (published on March 23, 2005).

Related Articles

- "*CDO Spotlight: CPPI Jostling To become Structured Credit Market's Next Big Thing*" (published on Feb. 2, 2006).
- "*Ratings Transitions 2005: Upgrades Outnumber Downgrades for First Time in European Structured Finance*" (published on Jan. 11, 2006).

All criteria and related articles are available on RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. The criteria can also be found on Standard & Poor's Web site at www.standardandpoors.com.

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