

# Update on Subprime and Related Rating Matters

November 1, 2007

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# Introduction

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- Standard & Poor's views on subprime and related matters:
  - Economic and Housing Outlook
  - Residential Mortgage-Backed Securities
  - Collateralized Debt Obligations
  - Asset-Backed Commercial Paper
  - Structured Investment Vehicles
  - Financial Institutions
  
- Information on:
  - Rating Actions
  - Current Assumptions
  - Recent Developments

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# U.S. Economic and Housing Outlook

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# The U.S. Recovery Has Slowed

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- The U.S. economy has slowed, after three strong years
- Not surprising after 17 consecutive Fed rate hikes
- Housing is the only major weakness; the rest of the economy is still growing near 3%
- The twin deficits are coming under control, with the government deficit at 1.9% of GDP last year
- Stronger overseas growth and a weaker dollar will mean less drag from the trade deficit; the underlying deficit has been shrinking for a year
- But could the credit squeeze turn the slowdown into a recession?

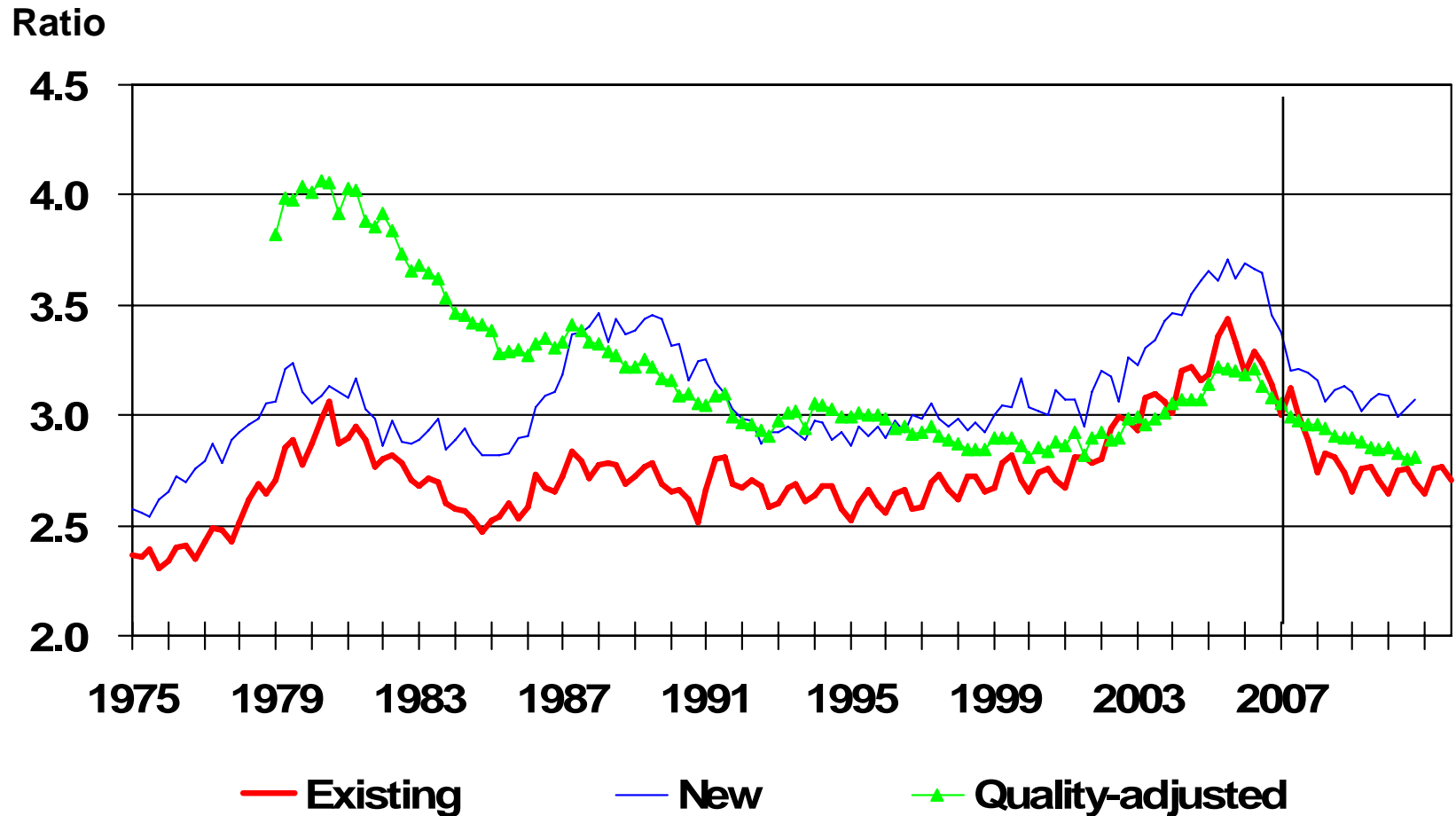
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# Home Prices Are High Relative to Household Income

## Ratio of average home price to average household disposable income



Source: BEA

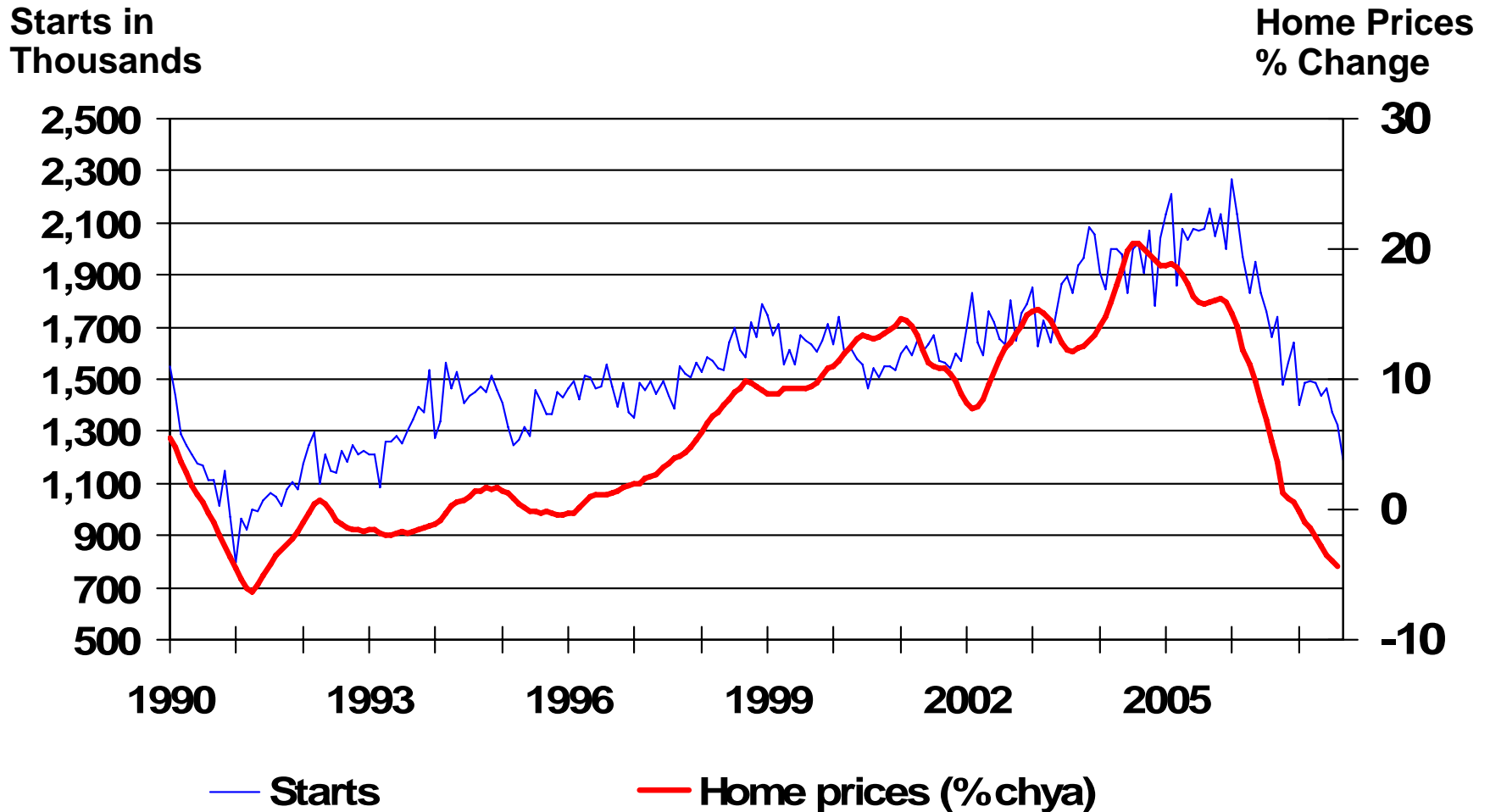
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# The Housing Market Cycle

## Housing starts and 12-month % change in home prices - S&P/Case-Shiller



Source: S&P and Census Bureau

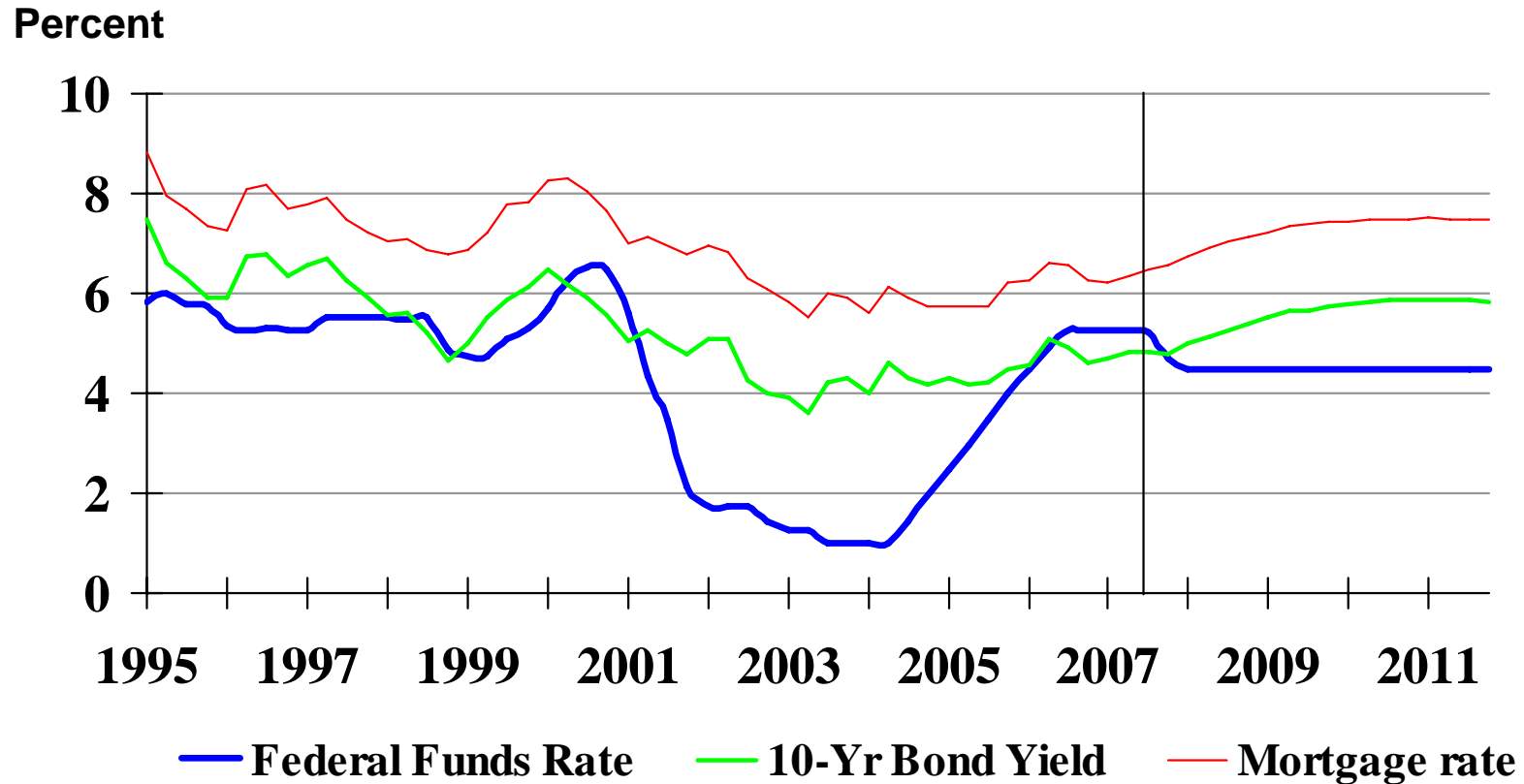
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# The Fed Will Cut Rates Sooner Than Expected

## Key Interest Rates



Source: Federal Reserve

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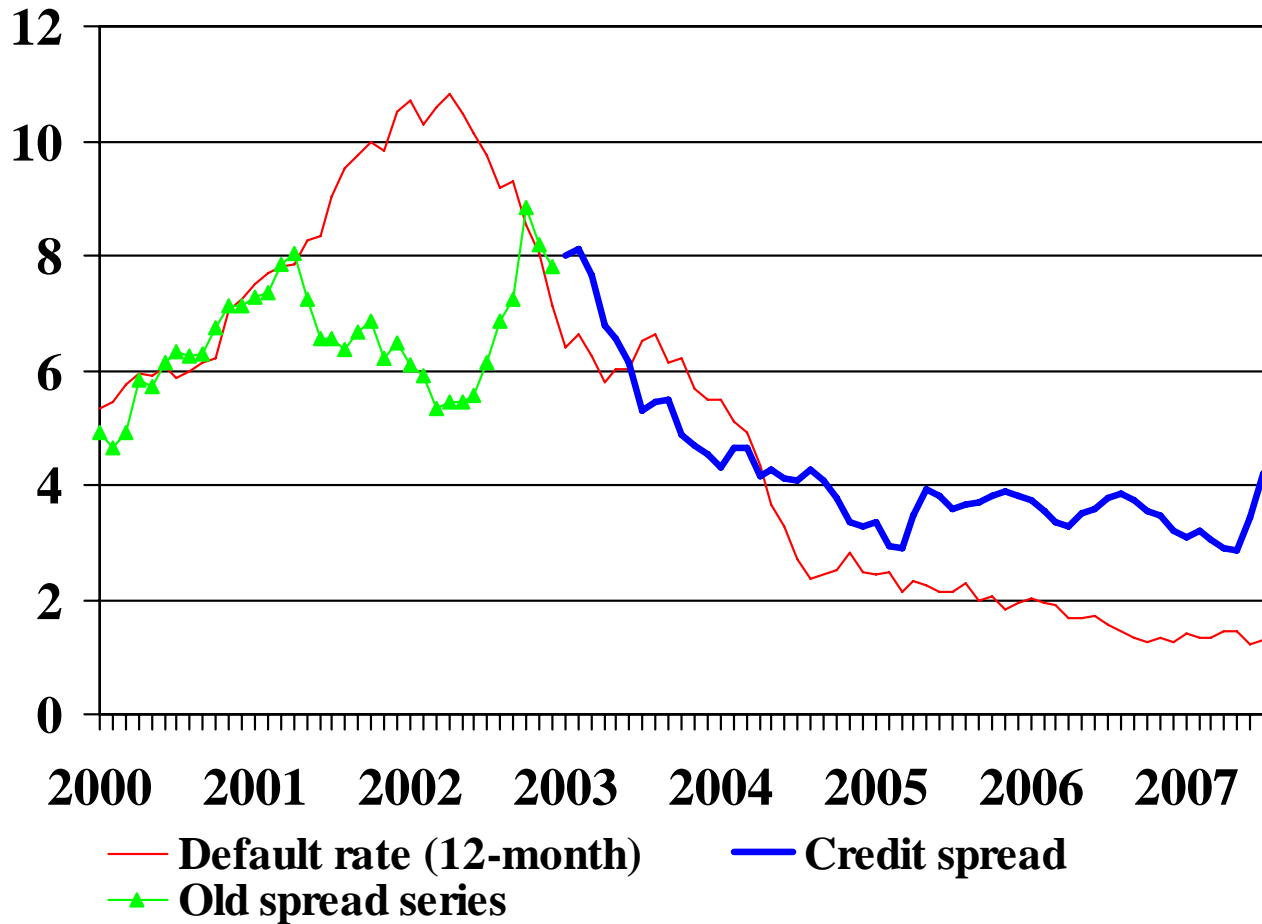
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# Quality Spreads Are Widening From Record Lows

## Spread over Treasury yields for speculative-grade corporates

Spreads in  
Percent Points



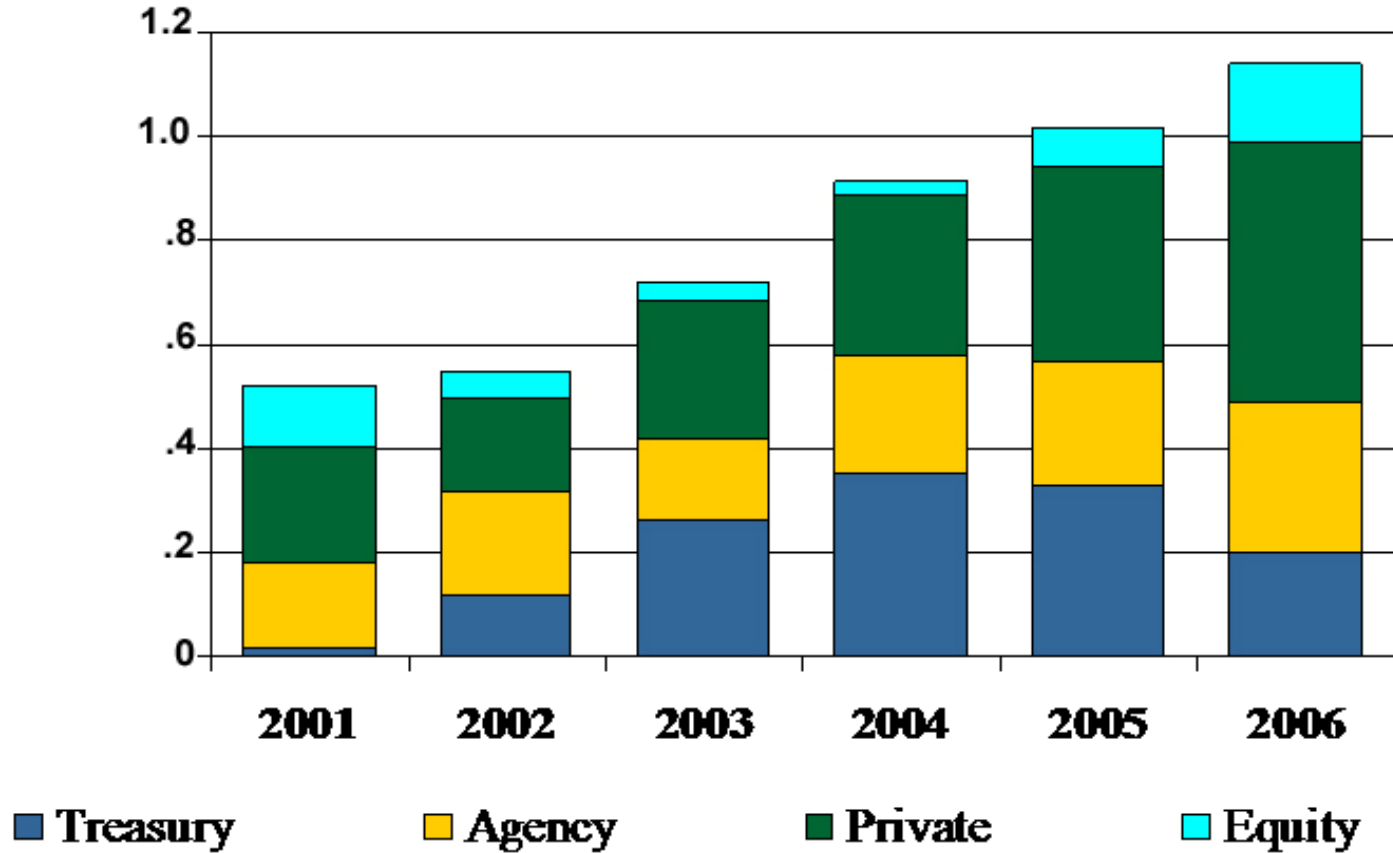
Source: S&P

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# Foreign Money Is Coming Into Private Bonds

## Net inflows of long-term capital

Trillions of Dollars



Source: US Treasury

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# RMBS Update

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## Performance of Underlying Mortgage Pools – Three Month Comparison

Subprime			
2005 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	0.73	21.93	13.18
Aug-07	0.83	23.56	14.40
Sep-07	0.91	25.45	15.87
2006 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	0.44	19.21	11.32
Aug-07	0.54	20.86	12.56
Sep-07	0.66	22.56	14.14
2007 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	0.01	7.45	2.49
Aug-07	0.02	9.45	3.83
Sep-07	0.05	11.80	5.49

Alt-A			
2005 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	0.06	6.81	3.42
Aug-07	0.06	7.08	3.66
Sep-07	0.08	7.39	4.00
2006 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	0.02	7.48	3.49
Aug-07	0.03	8.24	4.09
Sep-07	0.04	9.14	4.83
2007 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	0.00	2.62	0.67
Aug-07	0.00	3.74	1.10
Sep-07	0.00	4.83	1.79

Second Liens			
2005 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	4.74	11.85	5.72
Aug-07	5.28	13.04	6.38
Sep-07	5.80	13.99	6.92
2006 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	4.20	11.06	5.51
Aug-07	4.68	11.08	5.61
Sep-07	5.55	11.77	6.04
2007 Vintage			
	Cum Loss	Total Del	Serious Del
Jul-07	0.14	5.49	1.75
Aug-07	0.29	6.57	2.48
Sep-07	0.67	7.96	3.53

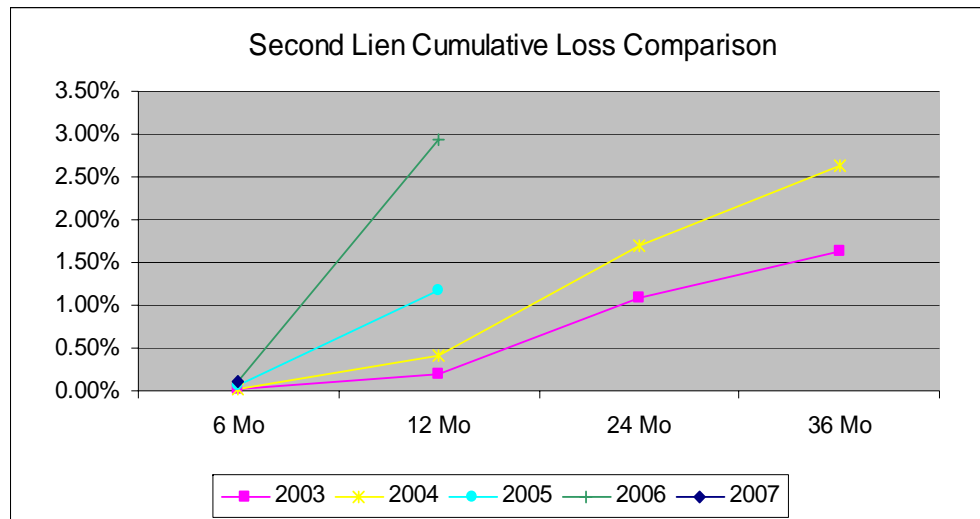
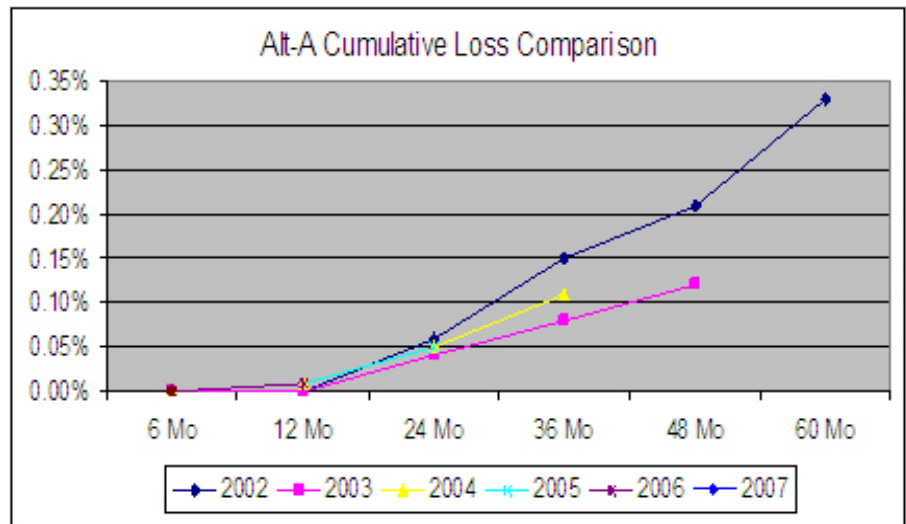
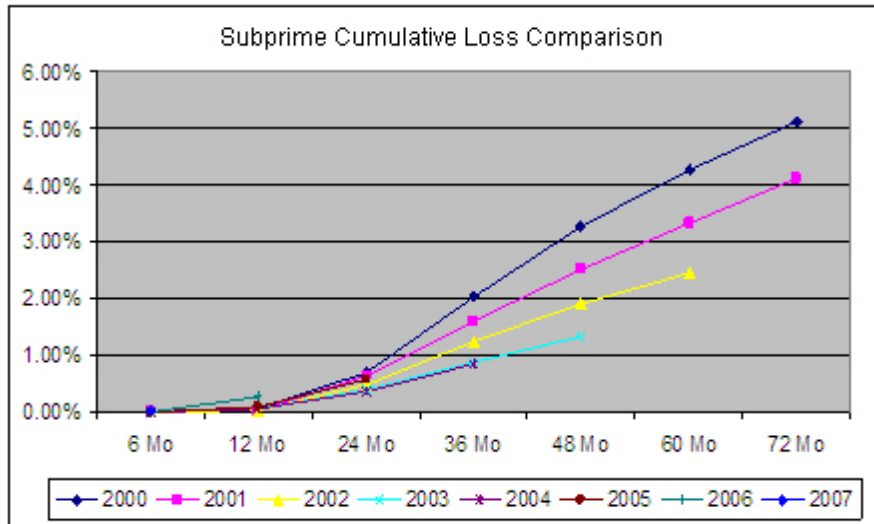
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# Performance of Underlying Mortgage Pools

## Cumulative Losses (All data as of Sept. 25<sup>th</sup>, 2007)



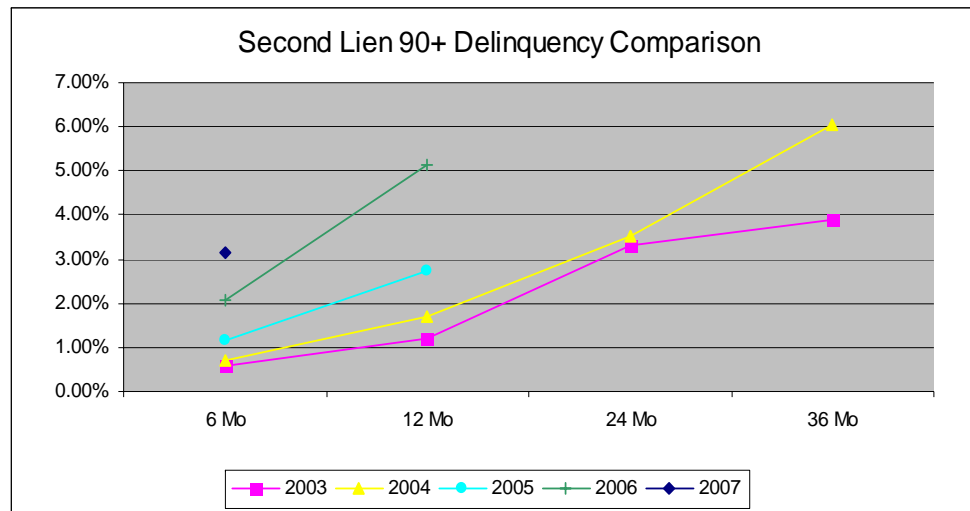
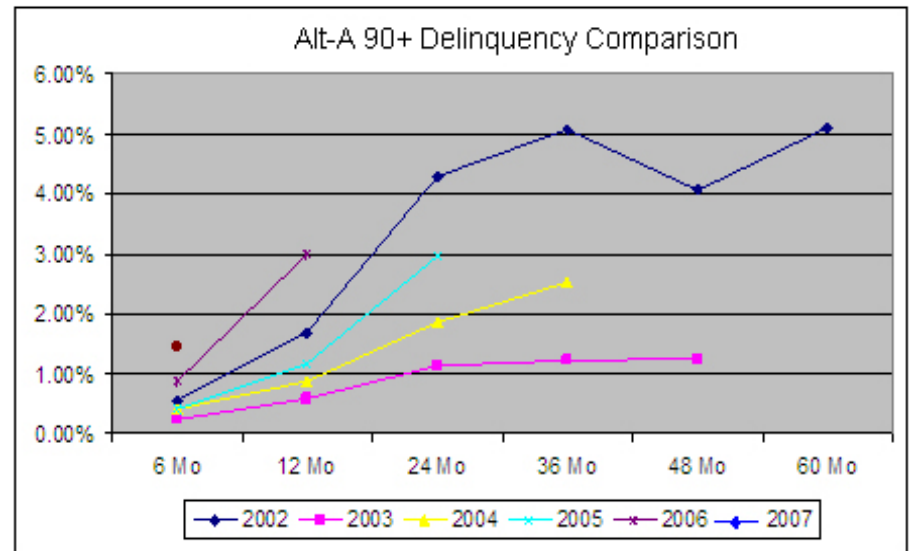
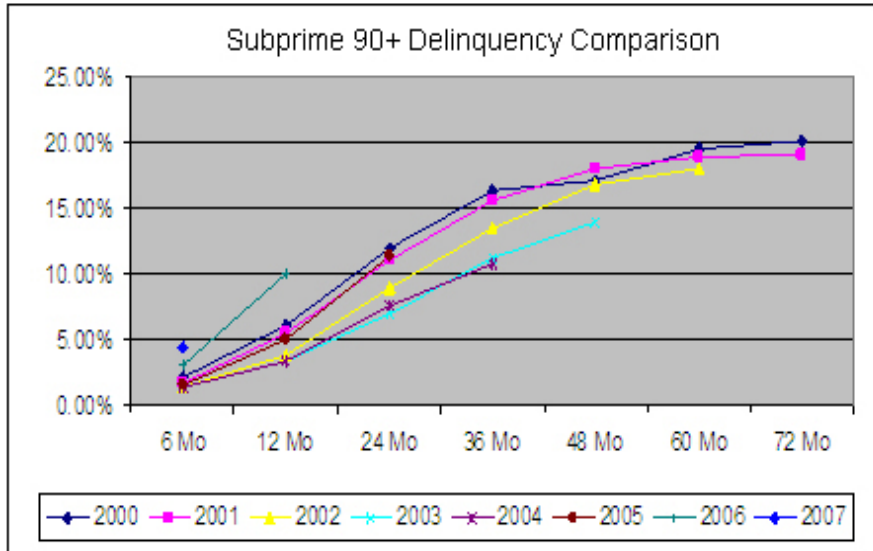
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# Performance of Underlying Mortgage Pools

## Serious Delinquencies (All data as of Sept. 25<sup>th</sup>, 2007)



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# Macro-economic Environment Considered in Surveillance Assumptions

- ARM re-sets cause increasing default trends to continue
- Servicers have limited loan modification success
- Assume 11% national home price declines through the end of 2008
- Local areas may experience greater declines
  - Speculative excess - Southern California, Las Vegas, Florida, Phoenix
  - Slowing economies - Michigan, Ohio, Indiana
- Steady macro-economic state with no recession
- No material increase in unemployment

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## 1Q 2005 – 3Q 2005 Transactions

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- Somewhat better credit performance than 2006
- Step-down trigger causes premature release of credit support
- Results lead to greater rating volatility
- Updated Surveillance Assumptions:
  - Loss severity assumption of 33% for Q1-Q2 2005 and 40% for Q3 2005.
  - Foreclosure inventory will be liquidated in approximately 15 months
  - REO inventory will be liquidated in approximately eight months
  - Utilize two sets of assumptions to determine future ratings

Project future losses from the current pipeline (July Assumptions)

Project future losses from a historical subprime default curve

Compare projected losses from the curve against actual losses: If actual losses are higher than projected, we used the most conservative method to adjust the ratings.

## 4Q 2005 – 4Q 2006 Transactions

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- Delinquency pipelines and cumulative losses have resulted in a reduction to actual and projected credit support
- Updated Surveillance Assumptions:
  - Loss severity assumption of 40% for Q4 2005 and 45% for 2006.
  - Foreclosure inventory will be liquidated in approximately 15 months
  - REO inventory will be liquidated in approximately 8 months
  - Utilize two sets of assumptions to determine future ratings

Project future losses from the current pipeline (July Assumptions)

Project future losses from a historical subprime default curve

Compare projected losses from the curve against actual losses: If actual losses are higher than projected, we used the most conservative method to adjust the ratings.

## 1Q 2007 – 2Q 2007 Transactions

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Underperformance continues for January – June transactions in Subprime, Alternative A & Second Lien sectors

Updated Surveillance Assumptions:

- All deals run through updated new rating assumptions
- Updated default expectations stress foreclosure rates
- Cash flow modeling assumptions limit excess spread credit
- Original capital structure and credit support compared to new assumptions
- Deals settled in January – April impacted by 90+ day delinquency rates
- Loan characteristics most associated with early payment defaults
- More stressful cash flow analysis – limits credit for excess spread

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## Recent Developments & Announcements

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- S&P institutes structural mitigants to step down trigger
  - OC Floor calculated on a deal level basis
  - Average OC Floor increased to 50% of original target (orig. bal.)
  - Looking at alternatives to traditional step-down provisions
- Loan Level Data Requirement as of January 1, 2008
  - Request for Comment on requested fields
  - Increase transparency & ability to conduct loan level surveillance
- Loan modifications
  - Effect on new deals and surveillance of existing deals
- Data Quality
  - Focused review of originator's ability to deliver accurate information and limit fraudulent activity
  - Issuer questionnaire on capabilities and use of fraud and risk management tools
  - Share results with market

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## CDO Update

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## Recent Residential Mortgage Related CDO Rating Actions

### Cash Flow & Hybrid CDOs CreditWatch Placements on October 22<sup>nd</sup>:

- 590 Ratings from 176 U.S. Cash Flow and Hybrid CDO transactions were placed on CreditWatch negative
- Ratings were placed on CreditWatch negative to allow time for comprehensive cash flow analysis, communication with the collateral manager and for the committee review process
- By issuance amount, the \$20.616 billion in cash/hybrid CDO notes affected represents 2.25% of the total outstanding issuance amount of U.S. cash/hybrid CDO classes rated by S&P
- The 590 CreditWatched ratings represent 6.2% of U.S. cash/hybrid CDO classes rated by S&P
- The 40 'AAA' CreditWatched ratings represent 1.12% of S&P's U.S. cash/hybrid CDO 'AAA' class ratings
- 94.8% of the CreditWatched ratings (559 of the 590) came from Mezzanine SF CDOs of ABS; the remaining came from High Grade SF CDOs of ABS

Cash Flow & Hybrid CDO of ABS Ratings Placed on CreditWatch Negative on October 22, 2007									
CDO Vintage	2001	2002	2003	2004	2005	2006	2007	Total (#)	Total (%)
AAA			1	2	2	22	13	40	6.8%
AA+			1		1	7	2	11	1.9%
AA			3	3	8	34	28	76	12.9%
AA-					1	14	7	22	3.7%
A+		1				5	3	9	1.5%
A			3	2	6	43	42	96	16.3%
A-	1		1		2	12	6	22	3.7%
BBB+			1			5	7	13	2.2%
BBB		2	3	12	16	62	51	146	24.7%
BBB-					2	20	37	59	10.0%
BB+		1			4	29	12	46	7.8%
BB		1	1		1	19	8	30	5.1%
BB-			1			3	3	7	1.2%
B+			1			1		2	0.3%
B		1				5	1	7	1.2%
B-			2			2		4	0.7%
<b>Total</b>	<b>1</b>	<b>6</b>	<b>18</b>	<b>19</b>	<b>43</b>	<b>283</b>	<b>220</b>	<b>590</b>	<b>100.0%</b>

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## Recent Residential Mortgage Related CDO Rating Actions

### Non-Excess Spread Synthetic CDO Downgrades on October 23<sup>rd</sup>:

- 145 ratings from 97 U.S. Synthetic CDO transactions were lowered
- Ratings were lowered after generating SROCs for the transactions that have exposure to the RMBS classes downgraded during the week of October 15th
- By issuance amount, the \$3.68 billion in synthetic CDO notes affected represents 1.5% of the total outstanding issuance amount of U.S. synthetic CDOs rated by S&P
- The 145 lowered ratings represent 4.5% of the U.S. synthetic CDO classes currently rated by S&P
- The 26 lowered 'AAA' ratings represent 2.21% of S&P's U.S. synthetic CDO 'AAA' class ratings
- 97% of the overall affected ratings come from CDOs originated in 2006 or in 2007
- All of the lowered ratings come from Mezzanine SF CDOs of ABS

Non-Excess Spread Synthetic CDO of ABS Downgrades on October 23, 2007																
From Rating	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	Total
AAA	15	9	1	1												26
AA+		4	1	1				1								7
AA			1	1	2	2	1									7
AA-				4	1											5
A+					2	6	9	1	4							22
A						4	3	3								10
A-							9	1								10
BBB+								10	7	5	2					24
BBB									8	6	1		1			16
BBB-										4	1	2	3			10
BB+													2	2		4
BB													1			1
BB-													1	1	1	3
<b>Total</b>	<b>15</b>	<b>13</b>	<b>3</b>	<b>7</b>	<b>5</b>	<b>12</b>	<b>22</b>	<b>16</b>	<b>19</b>	<b>15</b>	<b>4</b>	<b>2</b>	<b>8</b>	<b>3</b>	<b>1</b>	<b>145</b>

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# Residential Mortgage Related Actions To Date

- To date, 381 tranche ratings from 173 CDO transactions have been lowered, and another 709 tranche ratings from 193 transactions are currently on CreditWatch negative:

## High Grade SF CDOs of ABS:

- Collateralized primarily by senior (“AAA” and “AA” rated) tranches of RMBS transactions, but have some exposure to mezzanine RMBS tranches by holding senior tranches of Mezzanine SF CDOs
- No downgrades to date, but 34 tranche ratings from 14 cash flow transactions are currently on CreditWatch negative

## Mezzanine SF CDOs of ABS:

- Collateralized primarily by mezzanine (‘A’ rated and below) tranches of RMBS transactions
- 77 tranche ratings from 19 cash flow & hybrid CDOs have been lowered to date; another 671 tranche ratings from 176 transactions are currently on CreditWatch negative
- 258 tranche ratings from 145 synthetic CDO transactions have been lowered to date; one additional tranche rating is currently on CreditWatch negative

## Trust Preferred REIT CDOs:

- Collateralized primarily by subordinated mortgage REIT debt
- Because of recent conditions in the mortgage markets, many mortgage originators and purchasers (including REITs) have faced challenges in obtaining funding to finance their ongoing operations
- 46 tranche ratings from 9 Trust Preferred REIT CDO transactions were lowered on September 13<sup>th</sup>; two additional tranche ratings from one transaction are on CreditWatch negative

## Other Types of CDOs:

- One rating from a CDS referencing a CreditWatched cash flow CDO tranche is on CreditWatch negative

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## Percentage of RMBS Related U.S. ABS CDO Downgrades (DG)

Rating Categories	CDO Tranches DG due to RMBS Actions	CDO Tranches DG as a % of RMBS CDO Tranches Rated*	CDO Tranches DG as a % of Total CDO Tranches Rated*
AAA	51	3.00%	1.04%
AA	55	7.19%	2.52%
A	71	10.82%	3.54%
BBB	64	7.65%	2.89%
BB	13	5.00%	1.25%

\* Outstanding Cash, Hybrid and Synthetic CDOs as of 26<sup>th</sup> October 2007

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## ABCP Update

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# Granular Mortgage Data Backing ABCP

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## All Data as of August 31, 2007

• Percentage of U.S. \$ ABCP Outstanding Rated by S&P	95.5%	
• U.S. Residential Mortgage Exposure % of Rated ABCP	18.5%	
		<u>% ABCP</u>
• <b>RMBS Securities</b>	<b>8.3%</b>	
– Securities backed by Prime Assets		1.0%
– Securities backed by Non Prime Assets		7.3%
• <b>Whole Loan Mortgage Pools</b>	<b>4.5%</b>	
– Pools backed by Prime Assets		2.4%
– Pools backed by Non Prime Assets		2.1%
• <b>Indirect Exposure via CDOs</b>	<b>5.7%</b>	
– Included RMBS backed by Prime Assets		0.6%
– Included RMBS backed by Non Prime Assets		5.1%
	<b>»Total</b>	<b>18.5%</b>

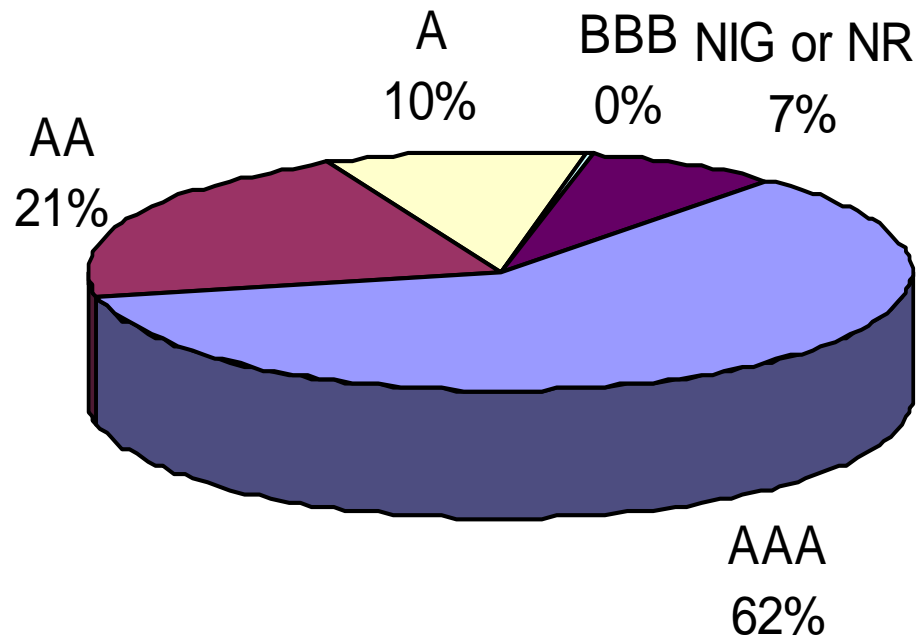
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## RMBS Securities by Rating (as of August 31, 2007)

### Ratings of RMBS Securities Financed through ABCP



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## ABCP Program Update (from August 14, 2007)

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- 13 of 18 conduits have retired all outstanding ABCP
- One conduit continues to wind down
- One conduit continues to roll its ABCP and intends to remain operational
- Three conduits had rating actions. Repayment of the liabilities remains at the discretion of the noteholders who have taken control of the disposition of the assets.
- In the aggregate these 18 programs have retired more than \$39.5 bn in extendible ABCP. This represents a 81% reduction in outstanding extendible ABCP for these vehicles since July end.

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## SIV Update

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# SIVs

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- 30 SIVs rated (1988-2007), 29 ratings remain (two merged)
  - Two (Cheyne, Rhinebridge) insolvent (senior ratings of “D”).
  - One (Kestrel) senior ratings are on credit watch negative (remains A-1+/AAA).
  - Two (Axon, Victoria) senior ratings have been downgraded (Axon to BBB, Victoria to AA).
- Defaults - Order of Magnitude
  - Prices have dropped beyond any precedent. Example Class: HEL
    - Maximum annual spread change observed for AAA: 22 bps.
    - 2007 observation for AAA: +400 bps.
    - Change in annual standard deviation: 18 times.
    - Change from all time min and max observed: approximately seven times.
    - AA: the change is 55 times max annual and 12 times all time min and max differential.
- Observation
  - SIVs grew from \$200 billion in outstanding debt to \$400 Billion in 36 months. Money Market Funds have significant cash amounts to invest and 2(a)7 product will be created. The assets funded included those tied to the U.S. economy. The implication is that asset-liability mismatch will not disappear because the financial system is unlikely to allocate balance sheet to cover the U.S. economy (ABS).

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## Weighted-Average NAV Of SIVs

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- End June 2007: 102.04%
- Mid July 2007: 101.52%
- End July 2007: 79.78%
- End August 2007: 79.74%
- End September 2007: 74.48%

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## Questions Most Frequently Asked

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- The severity of ratings moves?
  - Volatility climbed from the equity level to AAA as summer closed. This reality was reflected in the data we received in August. Prices moved quickly as pricing services received new quotes from dealers that were significantly lower each week.
  - Managers did not liquidate at the first sign of trouble but rather looked to lengthen liability structure or slowly de-lever. It left a significant overhang of potential ABS sales. This accelerated drops observed in the prices.
- What's going on today?
  - Restructuring proposals: multiple proposals.
  - NAV tests: Erosion continues as asset sales proceed. Leverage is decreasing. Asset pricing is a big issue. What is a “fair price” and “sell to whom”?
  - Liquidity: The tests to size facilities are no longer analytically relevant. SIV issued CP is generally not rolling. Since the liabilities are less liquid, the focus shifts to the liquidity of assets that will either be sold in the market or valued as part of the refinancing of the assets.
  - Repurchase (“Repo”) funding: nice short term solution but not a long-term answer as banks ultimately would have to consolidate.

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# Financial Institutions

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# FI Challenges: Credit Repricing and Market Turbulence

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Remainder '07: Earnings Under Pressure:

We expect significant bank loan and mortgage-related securities markdowns; reduced earnings in investment banking and trading; increased credit losses; lower mortgage Origination Market.

Short-term liquidity has tightened, forcing central banks to take actions

Unfavorable market conditions for mortgage finance

- Uncertainty of pricing prime jumbo loans
- Subprime – lower volumes and weak credit

Financial institutions most affected by correction:

- Specialty mortgage finance – dependence on securitization markets; exposure to hung leveraged loans
- Mortgage concentrated franchises - lending and capital markets

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# FI Challenges: Credit Repricing and Market Turbulence

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- Large financial conglomerates face turmoil from a position of strength
- Investment banking and trading will suffer, but leading broker/dealers have strength to absorb a stress worse than 1998
- Near-term central bank policy will be crucial
- Skillful liquidity management at a premium
- Underlying credit risk of borrowers remains good by historical standards
- A tale of two mortgage markets:
  - Layered risk vs. fully underwritten
- Correction may ultimately benefit the financial sector -- more differentiated pricing of credit; lower tolerance for leverage

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# Appendices

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# Appendix 1 Original-to-Current Rating Transitions – U.S. RMBS, CDOs of ABS, and SIV-lites, Q1 2005 – Q3 2007

Original-to-Current Rating Transitions																									
SECTOR = U.S. RMBS & CDO of ABS and SIV-Lite											For Vintages: Q1 2005 - Q3 2007							Date Updated = Oct. 29, 2007							
Original/Current	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC+	CCC	CCC-	CC	C	D	# of Ratings	# of Down	Down %
AAA	3580	32	22	7	11	2	1	1	2	0	0	0	0	0	0	0	0	1	0	2	0	1	3662	82	2.24%
AA+	0	2136	17	11	7	1	6	7	1	1	3	0	0	0	0	0	0	0	0	0	0	0	2190	54	2.47%
AA	4	4	3800	51	35	25	18	23	12	6	2	9	0	3	2	0	0	0	0	2	0	1	3997	189	4.73%
AA-	0	1	8	1452	55	53	41	31	13	17	4	22	2	0	3	0	0	3	0	0	0	0	1705	244	14.31%
A+	0	0	0	0	1447	44	58	78	31	12	19	41	3	3	16	4	0	3	0	0	0	0	1759	312	17.74%
A	0	0	3	1	1	2778	63	87	78	34	28	76	4	10	41	5	0	14	0	0	0	0	3223	440	13.65%
A-	0	0	0	0	1	0	1455	104	80	69	37	82	22	14	93	26	0	63	0	0	0	3	2049	593	28.94%
BBB+	0	0	0	0	0	0	1	1227	48	77	98	126	16	16	116	10	0	64	0	0	0	5	1804	576	31.93%
BBB	0	0	0	0	0	2	2	0	2397	89	124	160	25	29	179	11	1	123	0	1	0	8	3151	750	23.80%
BBB-	0	0	0	0	0	0	2	0	1	1349	85	149	71	38	229	63	0	286	0	1	0	16	2290	938	40.96%
BB+	0	0	0	0	0	0	0	0	0	0	433	48	31	39	118	25	0	244	0	0	0	40	978	545	55.73%
BB	0	0	0	0	0	0	0	0	0	1	1	1299	33	22	105	32	0	182	0	0	0	31	1706	405	23.74%
BB-	0	0	0	0	0	0	0	0	0	0	0	0	91	5	9	2	0	6	0	0	0	4	117	26	22.22%
B+	0	0	0	0	0	0	0	0	0	0	0	0	0	1	24	0	1	0	3	0	0	0	29	4	13.79%
B	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	978	45	0	42	0	0	1	1067	88	8.25%
B-	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	25	0	3	0	0	0	0	28	3	10.71%

Notes:

1. AAA ratings from the same transaction are treated as a single rating in the calculation of this table.
2. Multiple rating actions are aggregated to calculate a security's cumulative rating performance

Investment Grade	34	25830	4178	16.17%
Speculative Grade	76	3925	1071	27.29%
ALL	110	29755	5249	17.64%

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## Appendix 2: U.S. RMBS Downgrade Weighted by Original Dollar Issuance For Vintages Q1 2005 - Q2 2007

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	Subprime	Alt-A	CES	U.S. RMBS
Downgrade As a % of Original Issuance Rated by S&P	4.58%	0.37%	11.45%	2.58%
Downgrade As a % of U.S. RMBS Rated by S&P	1.78%	0.12%	0.34%	2.58%
Original \$ Issuance (in million)	\$1,030,889.1	\$879,798.8	\$79,492.5	\$2,647,295.4
Downgraded Original \$ Issuance (in million)	\$47,183.3	\$3,231.8	\$9,104.5	\$68,331.4

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