

RESEARCH

S&P Testimony On The Role Of Securitization In The Subprime Mortgage Market

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(Editor's Note: On April 17, 2007, Susan Barnes, Managing Director of Residential Mortgage-Backed Securities for Standard & Poor's, testified before the U.S. Senate Banking, Housing and Urban Affairs Committee's Securities, Insurance and Investment Subcommittee. The following is the text of her prepared remarks.)

Mr. Chairman, Members of the Subcommittee, good afternoon. I am Susan Barnes, Managing Director of Residential Mortgage-Backed Securities for Standard & Poor's Ratings Services ("S&P"). I appreciate the opportunity to appear before you today.

As requested, my testimony today will cover the following topics:

- The mechanics and structure of the mortgage loan securitization business;
- The residential mortgage-backed securities (RMBS) ratings analysis with particular focus on the factors we consider when evaluating mortgage securities backed by subprime mortgage loans; and
- The impact of current mortgage loan delinquencies and defaults on the performance of RMBS transactions backed by subprime mortgage loans.

Let me begin by first saying, S&P has been closely following the recent events in the subprime mortgage market and their impact on existing and future ratings of residential mortgage-backed securities.

S&P, which is a part of The McGraw-Hill Companies, Inc., began its credit rating activities 90 years ago, and today is a global leader in the field of credit ratings and credit risk analysis. Over that time, S&P has established an excellent track record of providing the market with independent, objective and rigorous analytical information and credit rating opinions. A rating from S&P represents our opinion on the future creditworthiness of a specific obligor or a particular financial obligation. In brief, a rating is our opinion on the future likelihood of payment of principal and interest on a security in accordance with its terms. Our ratings have been shown to be reliable indicators of the potential likelihood of default, in the aggregate, by rating category. Once published, we monitor ratings on an ongoing basis.

Although we comment on credit risk, our credit rating opinions are not intended to be and are not to be viewed as:

- Recommendations to buy, sell, or hold a particular security;
- Comments on the suitability of an investment for a particular investor or group of investors;
- Personal credit recommendations to any particular user of the ratings;
- Approval of possible extensions of credit or particular loans; or
- Investment or financial advice of any kind.

More detail on the nature of our rating opinions is available on our Web site at www.standardandpoors.com.

Credit ratings are an important component of the global capital markets and over the past century have

served investors extremely well by providing an effective and objective tool to evaluate credit risk. Credit ratings provide reliable standards for issuers and investors around the world, facilitating efficient capital raising and the growth of new markets. S&P conducts its business grounded in the cornerstone principles of independence, transparency, credibility, and quality. These principles have driven our long-standing track record of analytical excellence and objective commentary.

Studies on rating trends have repeatedly shown that there is a clear relationship between the initial rating assigned by S&P and the likelihood of default: the higher the initial rating, the lower the probability of default and vice versa.

For structured finance transactions, our Global Structured Finance Default Study published in January 2007 shows that the relationship between ratings and observed default rates was consistent with our expectations. The average one-year default rates since 1978 were near zero (0.04%) for investment-grade securities and 2.33% for speculative-grade securities. The same pattern prevailed across two- through five-year periods while the default rates were increasing. For example, the average five-year default rate for investment-grade securities was 0.87% and 15.42% for speculative-grade securities. Specifically, for the last five years (beginning in January 2002 and ending in December 2006), the five-year default rate among structured finance securities rated investment-grade globally was 1.29%, compared with 16.92% for structured finance securities rated speculative-grade.

The Mechanics Of The Mortgage Loan Securitization Business

The dynamics of today's mortgage banking business rely heavily on the ability to securitize mortgage loans. Typically, a mortgage originator receives an application for a loan by a prospective borrower, usually through a mortgage broker or via the lender's retail branch office network. An originator will underwrite the loan (decide whether to lend the funds to a borrower) by looking at the following four factors: the borrower's current income in relation to the size of the mortgage loan, the borrower's credit history (including the FICO score), the appraised value of the house that secures the mortgage, and the size of down payment for the loan. The market generally refers to mortgage loans as "prime" or "subprime." Prime mortgage loans are generally granted to borrowers with average FICO scores of 730, with loan-to-value ratios of 50%-80%, and borrower income to loan payment ratio no greater than 36%. Subprime mortgage loans are typically granted to borrowers with average FICO scores of 610, loan-to-value ratios of 80%-100%, and borrower income to loan payment ratios of 45%-50%. Once the loan is underwritten and approved in accordance with the parameters of the lender's underwriting standards, the borrower receives the proceeds of the mortgage loan.

Historically, a lending institution used its own capital funds or proceeds from unsecured borrowing to provide these mortgage loans, thus self-funding the lending process. The institution would hold the mortgage loans on its balance sheet, and would bear all of the credit and interest rate risk of the mortgage loan for the entire term of the loan. The institution would also bear the funding risk: the risk of mismatch between the maturity of the mortgage loan and the maturity of its unsecured borrowing. This funding risk was magnified in times of volatile interest rates, making risk management difficult. Credit, interest rate, and funding risk contributed significantly to the banking system stress in the early 1980s and led to the development of the mortgage finance market.

Today, once a mortgage loan is originated, the originator generally may:

1. Hold the mortgage loan on its balance sheet and take both the credit and interest rate risk;
2. Sell the mortgage loan to another financial institution as a whole loan sale;
3. Sell the mortgage loan directly into a securitization; or
4. Sell the mortgage loan to a mortgage conduit or loan aggregator, who in turn, may securitize the mortgage loan.

Today's mortgage market consists of thousands of mortgage lenders that either securitize their own mortgage loans or sell loans to conduit operations set up to issue mortgage-backed securities to capital market investors. In 2006, over 55% of all mortgage loans originated were packaged together and sold as mortgage-backed securities into the capital markets to investors.

A mortgage-backed security generally represents an undivided interest in the mortgage pool and the

holders of the mortgage-backed securities become the ultimate owners of the loans. As the borrowers repay their principal and interest obligations each month, those funds are collected and passed through to the investors. The holders of the mortgage-backed securities have the rights to receive the future cash flows generated by the repayment of interest and principal on the underlying mortgage loans. These cash flows are distributed to investors in accordance with the predetermined structure and payment priorities agreed upon at the closing of the mortgage-backed securities transaction.

Essentially, the issuance of mortgage-backed securities channels funds from investors in the capital market directly to homeowners, through the intermediary of the mortgage originators. The securitization process allows subprime lenders access to liquidity to fund their mortgage originations. Furthermore, since most of the credit risk associated with mortgage lending gets transferred or sold through the securitization process, from the lender to the security-holder, securitization is not only a source of diversified collateralized funding, but also a critical risk management tool.

The Structured Finance Credit Rating Process

As a fundamental matter, and in their most simple form, structured financings legally isolate assets from any previous owner's insolvency, to enable a purchaser of securities backed by those assets to rely solely on the creditworthiness of those assets. Thus, the structure seeks to insulate payment on the structured finance securities from the risk of default of any such previous owner that is unrated or has a credit rating lower than the desired rating of the structured financing. In other words, S&P is able to base its ratings on the credit aspects of the isolated assets, or asset pools, without regard to the creditworthiness of any previous owner, seller, or contributor of the assets.

Our credit analysis generally addresses (1) the credit quality of the pool of securitized assets, (2) structural and legal risks of the transaction, (3) the payment structure and the cash flow mechanics of the securities, (4) relevant operational and administrative risks, and (5) any other sources of payment for the securities, e.g., guarantees, swaps, or other forms of credit support for the transaction. This analysis enables us to reach an opinion on the creditworthiness of the structured finance security, commonly stated as: an opinion on the future likelihood of the payment of principal and interest on the security in accordance with its terms.

Our rating analysts review information submitted by participants in the transaction, e.g., issuers, underwriters, and servicers. In addition, we use various quantitative techniques and models to enhance our understanding of the performance of the transaction. During the rating process the transaction participants usually refine transactional (credit and structure) elements to reach the final structure and credit profile of the transaction, and may submit additional or revised information for our review. The analyst evaluates the information and prepares a recommendation for the rating committee.

To determine a rating, we convene a rating committee comprised of S&P personnel who bring to bear particular credit experience and/or structured finance expertise relevant to the rating. The qualitative judgments of the committee are an integral part of the rating process as it is through this process that asset and transaction specific factors, as well as changes in the market and environment, can be best assessed and addressed in the rating outcomes.

Once a rating is determined by the rating committee, S&P notifies the issuer and disseminates the rating to the public for free by, among other ways, posting it on our Web site, www.standardandpoors.com. Along with the rating, we frequently publish a short narrative rationale authored by the lead analyst. The purpose of this rationale is to make public the basis for S&P's analysis and enhance transparency to the marketplace.

After a rating is assigned, S&P monitors or "surveils" the ratings to adjust for any developments that would impact the original rating. The purpose of this surveillance process is to ensure that the rating continues to reflect our credit opinion based on our assumption of the future performance of the transaction. The surveillance process varies based on our assessment of risks to the transaction. If information leads the surveillance analyst to believe a rating change is warranted, the analyst will present the information to a rating committee, which will then determine whether the rating should be changed. When a rating change is anticipated or occurs, our analysts similarly publish the new rating and a related ratings rationale.

S&P has a long-standing policy of providing our public credit ratings and the basis for those ratings broadly to the investing public as soon as possible and without cost. Public credit ratings (which constitute more than 90% of our credit ratings in the United States) are disseminated via real-time posts on our Web site and through a wire feed to the news media as well as through our subscription services.

Evaluating Subprime Mortgage-Backed Securities

We turn now to a more detailed description of the securitization of subprime mortgage loans.

Subprime mortgage loans

Subprime mortgage loans are made to borrowers who typically have weak credit histories. In the past two years, subprime mortgage loans accounted for about 20% of all mortgage loans. However, if we look at only adjustable-rate and interest-only mortgage loans, subprime loans accounted for 40% of these mortgages in 2006.

The increased availability of mortgage credit to subprime borrowers has contributed to the increase in home ownership rates across the United States. This increase has occurred simultaneously with a rise in originators loosening their underwriting guidelines. This loosening of underwriting standards included low equity and little to no income verification loans to first-time homebuyers with weak credit histories.

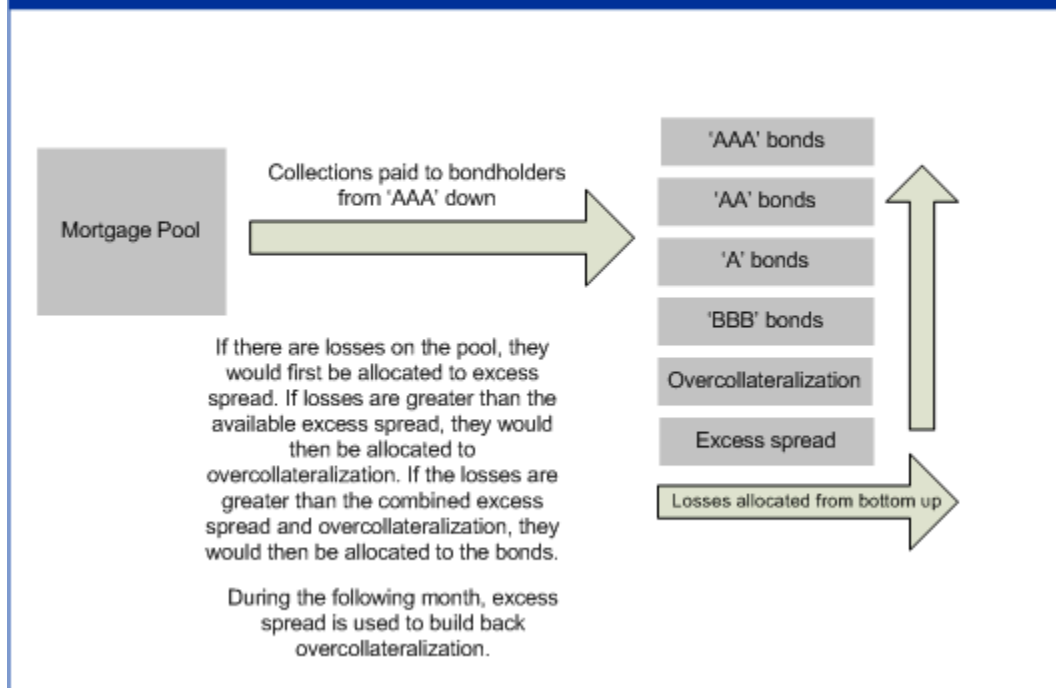
Assessing credit risk of mortgage-backed securities

S&P rates RMBS by analyzing the credit characteristics of the mortgage pool. The rating of each "tranche" or layer of an RMBS transaction (sometimes referred to as a series) is determined by analyzing the amount of credit enhancement provided to support the tranche. Credit enhancement is the protection (i.e., additional assets or funds) needed to cover losses under stress scenarios to achieve a desired credit rating on a mortgage-backed security. A stress scenario simulates changes in the performance of the mortgage loan due to changes in economic and market conditions. Typical forms of credit enhancement include:

- Excess spread: the difference between the amount of interest paid on the mortgage loans and the amount of interest owed on the bonds;
- Overcollateralization: a greater principal amount of mortgage loans in a pool than mortgage bonds offered. (For example, if a transaction is based on a mortgage pool of \$1,000,000 and only \$990,000 in mortgage bonds are issued, there is \$10,000—or 1.00%—in "overcollateralization.")
- Subordination: prioritizing the manner in which mortgage loan losses are allocated to the various layers of bonds.

For a given rating category, to determine the appropriate level of credit enhancement, we assess the sufficiency of the assets available to pay the given tranche based on the priority of payments established by the transaction documents. In the example below, the 'AAA' bonds are supported by the 'AA', 'A', 'BBB', overcollateralization, and excess spread, while the 'BBB' bonds only have the benefit of credit enhancement in the form of overcollateralization and excess spread. Therefore, the credit performance of each tranche is dependent upon the amount and availability of credit enhancement provided to a particular tranche.

**Chart 1
Typical Subprime Transaction**



As a practical matter, S&P's analysis of an RMBS transaction breaks-down into the following four categories:

1. Conducting a loan-by-loan collateral analysis using S&P's Loan Evaluation and Estimate of Loss System ("LEVELS") Model;
2. Reviewing the cash flow aspect of the structure using our Standard & Poor's Interest Rate Evaluator ("SPIRE") Model by simulating the cash flow of an RMBS transaction's underlying residential mortgage loans;
3. Reviewing the originator and servicer operational procedures; and
4. Reviewing the transactional documents for legal and structural provisions.

Once a rating is issued, S&P conducts ongoing surveillance.

1) Loan level collateral analysis (LEVELS model). S&P evaluates the overall creditworthiness of a pool of mortgage loans by conducting loan level analysis—each mortgage loan is analyzed individually. This analysis is performed using our LEVELS model. Our criteria do not dictate the terms of the mortgage loans; rather the originator in the underwriting process determines these terms. S&P will evaluate the loan characteristics which include, but are not limited to: the amount of equity a borrower has in the home; the loan type; the amount of income verification; whether the borrower occupies the home; and the purpose of the loan. This analysis allows us to quantify multiple risk factors, or the layered risk, and allows for an assessment of the increased default probability that is associated with each factor. Based on the individual loan characteristics, the LEVELS model calculates probabilities of default and loss realized upon default, and on a pool basis, helps us determine how much credit enhancement is needed to support the rated bonds.

In particular, by using the LEVELS loan level analysis, S&P was able to identify the trend of deteriorating credit quality of the mortgage loans in 2006, and to increase the credit enhancement requirements necessary to maintain a given rating. In essence, we increased the probability of default assumptions for loans with little to no equity in May 2006 and correspondingly increased our credit enhancement

requirements. Credit enhancement requirements for the average subprime transaction rated in 2006 increased by 50% as compared to deals from 2005.

2) Review of the cash flow modeling (the SPIRE model). An important aspect of our rating process is assessing the availability of cash flow (monthly payments) generated by the mortgage loans and available to pay principal and interest on the bonds presented to us for rating. The cash flow assessment, which is accomplished through the use of our SPIRE model, assumes certain stresses related to the timing of scheduled payments, as well as prepayments on the mortgage loans. The model uses the S&P mortgage default and loss assumptions (generated by the LEVELS model) and interest rate assumptions. The model simulates the cash flow of an RMBS transaction's underlying residential mortgage loans under various stress scenarios, and evaluates the availability and impact of various credit enhancement mechanisms on the transaction.

3) Review of the originator and servicer. S&P reviews the practices, policies, and procedures of the originators and servicers primarily to gain comfort with the ongoing orderly performance of the transaction. For an originator, the topics reviewed include, but are not limited to: loan production practices such as broker and appraiser monitoring; loan underwriting; and quality control practices and findings. This review is conducted to provide S&P a sense of the reliability of the information provided to us when a rating is requested and on which we base our analysis. It is important to stress that S&P neither expects, nor requires, a given origination process, but we will adjust the credit support calculation based on the underwriting employed at origination.

For servicers, the review is different and more in-depth than that for originators, as the servicer must continue to service the mortgage loan on behalf of the investors. Generally, for S&P to be willing to rate a transaction, the servicer must have a servicer evaluation of at least "Average," as provided in our servicer evaluation criteria. More detailed explanations of the servicer evaluation process can be found on our Web site. In general, servicer reviews encompass: cash management; investor reporting; management of defaulted loans, and management of properties acquired in foreclosures ("real estate owned" or "REO"); as well as internal processes and controls. Servicer performance is reviewed on an ongoing basis in accordance with our review cycles and our assessment of performance risk.

4) Review of transactional documents. S&P will review the legal documents, and where appropriate, opinions of third-party counsel that address transfer of the assets and insolvency of the transferor, as well as security interest and other legal or structural issues. S&P reviews the underlying documentation in order to understand the payment and servicing structure of the transaction. The underlying documentation forms the legal basis for the allocation of collections and losses to the various security-holders.

Unless the credit risk of an entity is factored into the rating, S&P's analysis assumes the bankruptcy of the transaction participants in order to base its credit judgment solely on the performance of a given asset pool.

Ongoing Surveillance

Mortgage loan pool performance information is disclosed in a report prepared monthly by the servicer, in accordance with industry standards. Prior to issuing a rating on a transaction, S&P analysts review the form of the monthly servicer report to determine whether it contains sufficient information to enable us to do our scheduled surveillance.

The surveillance process seeks to identify those issues that should be reviewed for either an upgrade or a downgrade because of asset pool performance that may differ from the original assumptions. The surveillance function also monitors the credit quality of all entities that may be supporting parties to the transaction, such as liquidity providers. Analysts review performance data periodically during the course of the transaction, and present that analysis to a rating committee for review of whether to take a rating action. The rating committee then decides whether the rating change is appropriate. For changes to public ratings, a press release is normally disseminated.

Additionally, the transaction documents generally require transaction participants to inform S&P of any changes to the original structure, including management, credit policy, system changes, or any change in the status of the parties involved in the transaction. The information is used as part of surveillance

maintenance for the transaction, based primarily on our view of the likely risk of downgrade or upgrade of the transaction.

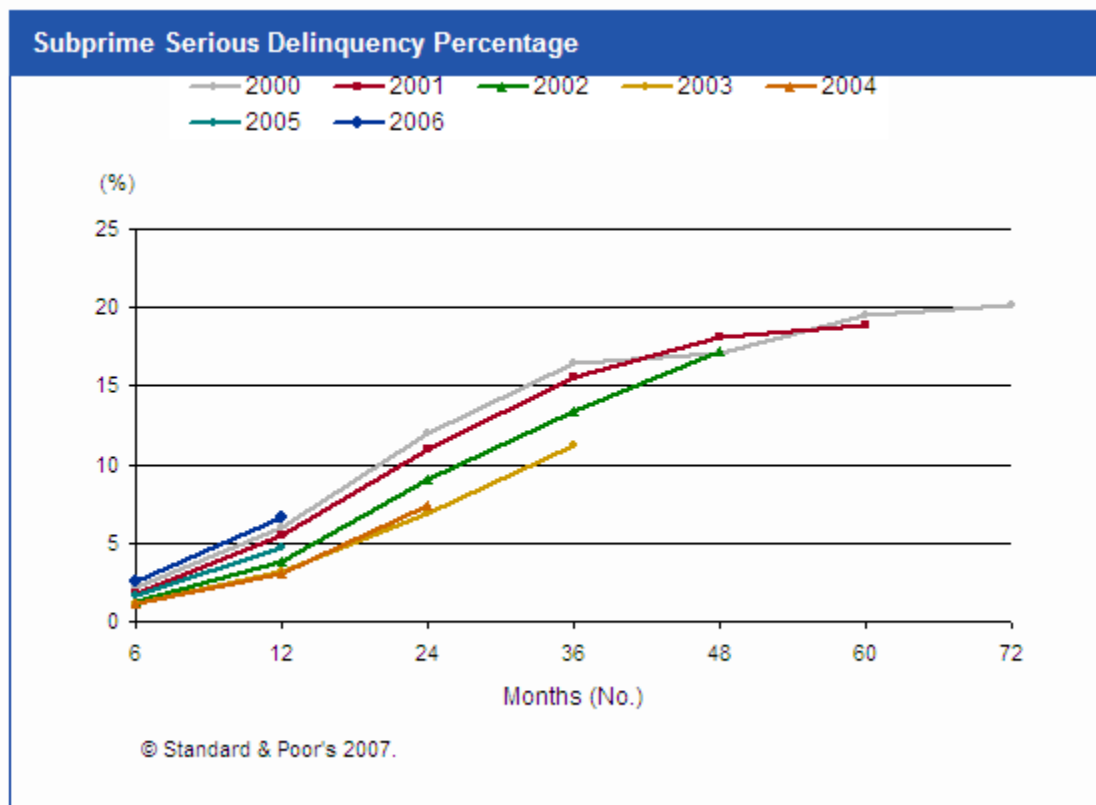
Between 1978 and 2006, S&P issued 46,912 RMBS ratings. Eighty-five percent were initially rated investment-grade: 'AAA' to 'BBB'. Of the \$3.6 trillion in par value of RMBS outstanding as of Jan. 1, 2007, 88.1% are rated 'AAA'. In general, then, the vast majority of residential mortgage-backed securities ratings have been investment-grade and very stable. S&P believes its models have captured the deterioration in the credit quality of the 2006 subprime mortgage loans.

Mortgage Loan Default And Delinquency Impact On The Subprime Securitization Market

The poor performance of subprime mortgage loans originated in 2006 has dampened investor appetite for subprime mortgage bonds. Accordingly, the interest rate sought by investors, given their risk appetite for mortgage bonds, has increased as compared to mortgage-backed bonds issued in prior years. Therefore, the securitization of subprime loans has become less economical, resulting in fewer subprime mortgage loan originations in 2007.

While delinquencies for the 2006 vintage are much higher than what the market has experienced in recent years, they are not atypical with past long-term performance of the RMBS market. For instance, serious delinquencies (90-plus days, foreclosure, and REO) for 2006 deals are nearly equal to delinquencies reported for the 2000 vintage after similar seasoning as evidenced by the chart below. However, we do expect the loans originated in 2006 will be the worst-performing in recent history.

Chart 2



Overall, S&P forecasts losses ranging from 5.25% to 7.75% for the subprime mortgage loans contained in RMBS transactions rated in 2006. This is slightly above the losses incurred by subprime mortgage loans in RMBS transactions rated in 2000, the previous worst-performing year, with average cumulative losses of about 5%.

We expect losses, and therefore negative rating actions, to keep increasing in the near-term relative to previous years because of likely minor home price declines through most of 2007. However, our simulations continue to reveal that as long as interest rates and unemployment remain at historical lows, and income growth continues to be positive, there is sufficient protection for the majority of investment-grade bonds.

Subprime transactions rated in 2006 have been performing worse than in recent vintages. This performance may be attributed to a variety of factors:

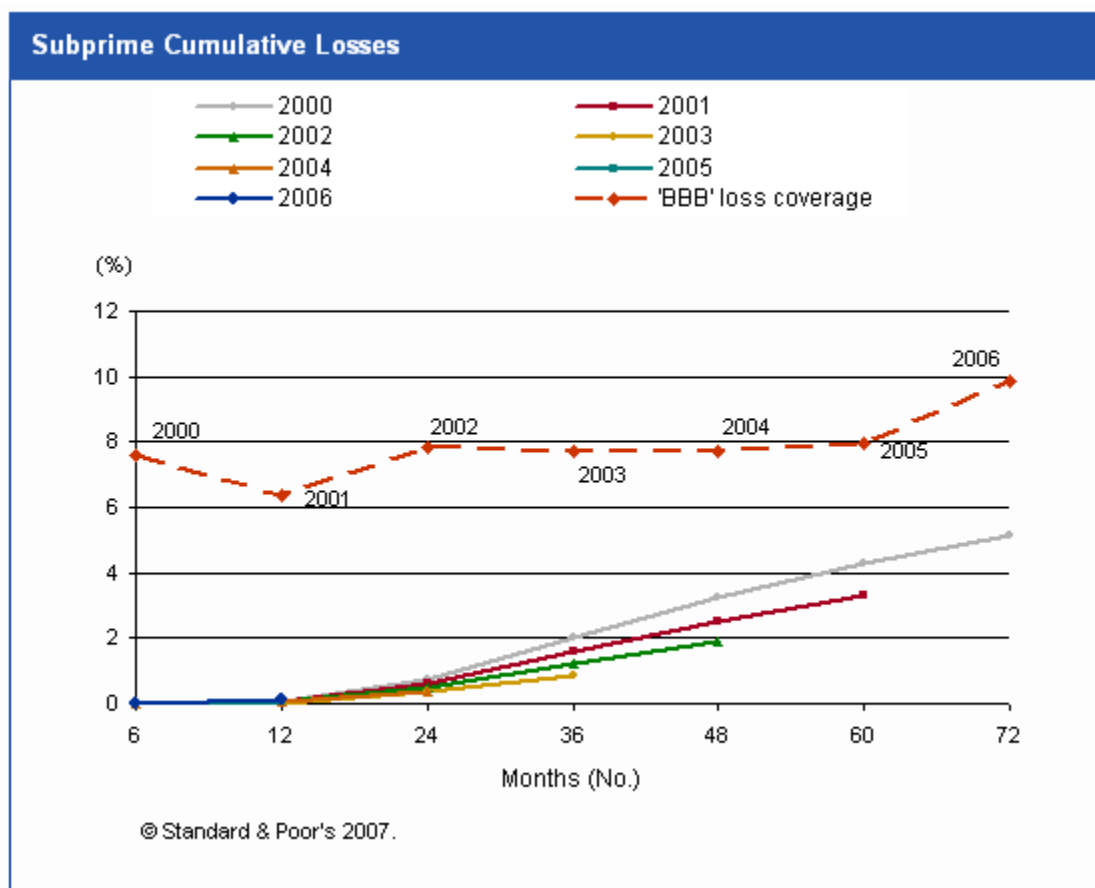
- Lenders underwriting guidelines that stretched too far;
- Home price appreciation rates that are slowing; and
- Adjustable-rate mortgage loans that in rising interest rate environments create a heightened risk that borrowers may not be able to make larger payments.

S&P is actively monitoring subprime mortgage transactions on a monthly basis. While we do not expect there to be widespread downgrades, if the marketplace or economy as a whole experiences further financial distress, there could be a more prolonged period of negative performance, and S&P may need to take further rating actions.

As of April 12, 2007, S&P has downgraded 30 tranches of various 2006 subprime, Alt-A, and second-lien transactions, and placed 64 classes on CreditWatch Negative. To put this in perspective, there are currently 32 subprime transactions affected out of 1,025 rated subprime transactions from 2006. That is only 0.3% of the outstanding ratings in the subprime area.

Subprime loan performance has declined, but as mentioned before, starting mid-2006, transactions began to include higher credit enhancement levels to account for increased probability of loss on subprime mortgage loan pools. The graph shows the average gap between losses experienced and losses that had served the basis for the analysis. The dotted line represents forecasted losses modeled into 'BBB' rated tranches for the years 2000 through 2007.

Chart 3



Loss Mitigation Options In Securitization

Given the current credit stresses in the subprime market, many servicers and investors are exploring loss mitigation options available to them. S&P views loss mitigation efforts as an important part of servicing securitized mortgage loans. If a large percentage of mortgage loans go into default and foreclosure, the principal amount of losses may be greater than the losses that would result from forbearance or restructuring the mortgage loans.

In an RMBS transaction, mortgage loan servicers are obligated to act in the best interest of the investors and in accordance with standard servicing industry practices. Generally, servicers have the ability to mitigate losses by, among other things, entering forbearance agreements, extending the amortization terms, adding balloon payments, and/or restructuring or decreasing the mortgage rates. The primary purpose of loss mitigation efforts is to assist distressed borrowers who are temporarily unable to meet their mortgage obligations, minimize losses for the lender and the borrower, and to provide the opportunity for the borrower to cure any payment defaults. Forbearance agreements will generally defer payments of interest and capitalize the amounts of deferrals to be paid later during the term of the loan or as a balloon payment. Restructuring the loans may involve a combination of revisions to the interest rates and/or extensions to the maturity of the loans. A restructuring may also change the interest from floating-rate to fixed-rate, to avoid future stresses on a borrower's ability to pay.

We believe that a majority of the transactions allow the servicer to forbear or restructure mortgage loans within generally accepted servicer and industry standards. Some structured finance transactions may have provisions that limit a servicer's ability to restructure the mortgage loans to a certain percentage of the loans.

Given the many loss mitigation options, and the potential impact on investors, S&P is sensitive to the

balance between the negative impact of the potential reduction in payments received from the borrower and available to pay investors, with the potential positive impact of a lower number of borrowers defaulting. So long as forbearance and restructuring of the subprime mortgage loans is consistent with industry standards, S&P believes that the ratings on the RMBS securities will not be negatively affected.

Financial Institutions And Lending Reform

S&P does not anticipate pervasive negative rating actions on financial institutions due to rising credit stresses in the subprime mortgage sector. Those financial institutions with diversified asset and mortgage lending and servicing operations, aligned with strong interest rate and credit risk management oversight, are well positioned to weather this downturn. Specialty finance companies that focus solely on the subprime market do not enjoy the protection provided by the diversification of loan portfolios and origination sources of the larger financial institutions, and have felt the effects of the current subprime credit stresses. Some of these entities have filed for bankruptcy protection and expect to restructure and emerge as viable entities. Others may look for opportunities for industry consolidation.

S&P strongly supports efforts to promote prudent lending practices. We have previously expressed this view in the context of predatory lending discussions, and perceive this matter as similar from a credit perspective.

For several reasons, we continue to urge that Congress exercise caution in crafting any legislative response to the current subprime lending situation. It is important to ensure that subprime borrowers continue to have access to fair and appropriate mortgage loans. If Congress should determine that legislation is the appropriate response, such legislation must provide clear guidelines to the market to ensure that there are no unintended consequences. Depending on the laws considered, a lender might reduce its activities within a given market sector if those loans are too costly to originate making it economically prohibitive. This would occur, for example, if a lending law imposes certain forbearance requirements intended to benefit borrowers or liability on purchasers or assignees of loans causing potential purchasers and assignees to reduce, or even cease, their purchasing of those loans to avoid liability under the law. Forbearance obligations (obligations to renegotiate the loans and/or reduce principal amount of the debt) may increase uncertainty in the performance of mortgage loan asset pools, and may affect repayment of the mortgage-backed securities. Investors may become unwilling to invest in subprime mortgage-backed securities, if the investment returns on the securities and/or the overcollateralization amounts are not raised commensurate with the increased risk. In other words, the return demanded by investors due to the uncertainty may make the origination and subsequent sale of such loans uneconomical, resulting in diminished availability of funds to borrowers.

From S&P's perspective, a second solution often proposed, a lending law that imposes liability on purchasers or assignees of mortgage loans ("assignee liability") to monitor and reduce unsafe practices in the lending market, also has significant downside risk. It might reduce the availability of funds to pay investors in securities backed by mortgage loans governed by the law, as the mortgage loan pool could be depleted by the amounts of any damages assessed to the trust. This would occur if the law placed responsibilities on the purchaser or assignee for violations attributable to the loan originator, even if the purchaser or assignee did not itself engage in prohibited lending practices.

If such laws were adopted, in performing a credit analysis of structured transactions backed by residential mortgage loans, S&P would evaluate the impact that such lending law might have on the availability of funds to pay the rated securities. To the extent that S&P determined that investors in securities backed by loans governed by a lending law might be negatively impacted, S&P could require additional credit support to protect investors or, in certain circumstances, preclude such loans from being included in S&P rated transactions. This again could reduce the availability of funds to prospective borrowers.

Conclusion

S&P recognizes the hardship the current subprime situation is placing on certain borrowers. However, as requested by this Subcommittee, we focused our comments on the effects the subprime market has on the financial sector.

As part of our rating and surveillance process for RMBS transactions, S&P actively monitors trends in the

housing market, the mortgage finance market, consumer credit, and the overall economy in order to ensure that our models, methodologies, criteria, and analysis (which incorporate our views about possible future market scenarios) are fully informed. As a result, we were able to identify the trend of deteriorating credit quality of certain subprime mortgage loans in 2006 and increase the credit support necessary to support a given rating. Going forward we will continue to make changes to our criteria, models, methodologies, and analysis to ensure that they appropriately reflect economic conditions.

Delinquencies and defaults in the subprime mortgage market have increased, and we expect that they will continue to increase. Therefore, we anticipate further downgrades in the ratings of the lower-rated tranches of subprime RMBS transactions. S&P continues to actively monitor the developments in the subprime market, and will continue to adjust its ratings accordingly.

Although S&P anticipates that subprime delinquencies and defaults will continue to increase, the pain in the financial sector from rising subprime mortgage loan defaults should be minimal for major banks because of their diversified income streams and because they have only a limited presence in this market. The financial players most affected will be stand-alone companies that specialize in subprime lending.

It is important to note that, absent the securitization market, the impact of credit stresses in the subprime mortgage sector would have been felt directly by the financial institutions. Thus, the securitization market has served to diffuse to a larger group of capital market investors, risks that 25 years ago would have gnawed at the foundations of the banking system. Securitization has proved to be both a source of increased liquidity in the mortgage market and a viable risk mitigation mechanism in periods of credit and market stress.

S&P also urges this Subcommittee to exercise care in crafting a response to the current credit stresses in the subprime market, as there is the potential for unintended consequences that could lead to further deterioration of the market and restrict liquidity in the subprime sector.

I thank you for the opportunity to participate in this hearing and am happy to answer any questions you may have.

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