August 5, 2008

Ms. Florence Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number S7-13-08
Proposed Rules for Nationally Recognized Statistical Rating Organizations

Dear Ms. Harmon:

The National Community Reinvestment Coalition (NCRC), on behalf of our 600 member organizations, applauds the Securities and Exchange Commission (SEC) for proposing rules that would enhance disclosure and provide additional firewalls between Nationally Recognized Statistical Rating Organizations (NRSROs), issuers of structured finance products, and other participants in asset-backed and mortgage-backed securities transactions.

On April 7, 2008, NCRC asked the SEC to thoroughly investigate the rating agencies' issuance of unwarranted ratings without first considering relevant information available at the time that should have been evaluated. NCRC attaches its April 7 letter to these comments, which more fully addresses the ratings agencies' failures. While the proposed rules' increased disclosure and increased management of conflicts of interest provisions are a step in the right direction in addressing NCRC's concerns, they are not sufficiently robust to address the failures that fueled the current mortgage crisis which has damaged communities across the country.

Credit rating agencies continuously provided inflated ratings to residential mortgage-backed securities and collateralized debt obligations, helping to propel the mortgage crisis. In the first three months of 2008 alone, 650,000 homes were subject to foreclosure actions. During the same time period, credit rating agencies performed a massive downgrading of their residential mortgage-backed securities. As of February 2008, Moody's downgraded 53 percent of its 2006 subprime residential mortgage-backed securities and 39.2 percent of its 2007 subprime residential mortgage-backed securities.[1] In March of 2008, S & P downgraded 44.3 percent of the subprime tranches it rated between the first quarter of 2005 and the third quarter of 2007[2]. In February of 2008, Fitch placed all of the residential mortgage-backed securities that it rated in

[1] Christopher Cox, Securities & Exchange Commission Chairman,Testimony Before the Banking, Housing, and Urban Affairs Senate Committee, April 22, 2008
[2] Christopher Cox, Securities & Exchange Commission Chairman,Testimony Before the Banking, Housing, and Urban Affairs Senate Committee, April 22, 2008

2006 and in the first quarter of 2007 backed by subprime first lien mortgages on Ratings Watch Negative.[3] These downgrades are tacit proof that the NRSROs irresponsibly inflated ratings.

Credit ratings agencies should be held accountable for their pivotal role in the mortgage crisis and guidelines should be put in place to ensure that these abuses cannot happen again. While NCRC generally supports the proposed rules, more needs to be done. NCRC is concerned that the proposed rules focus too heavily on increased competition as a method to facilitate more accountability and transparency in the credit rating industry. For example, the new disclosure rules allow many credit rating agencies to rate the same products and thereby expose a rating agency whose ratings were unduly influenced by an issuer. While NCRC supports business competition, a regulatory approach based upon the theory that the "market will take care of itself" is responsible for much of financial crisis we face today. NCRC encourages the SEC to strengthen its proposed rules to require more due diligence to verify the accuracy of financial data on structured products. Moreover, NCRC urges the SEC to seek lawful penalties from credit rating agencies that willfully provided inflated ratings.

NCRC supports the SEC's proposed amendment to prohibit an NRSRO from issuing a rating on a structured product unless information on the characteristics of the underlying assets is available. The rating agencies knowingly issued false and inflated ratings for securities backed by problematic high-cost loans that have created a financial nightmare for millions of families whose homes are now in foreclosure. Additionally, rating agencies failed to correct erroneous ratings, or changed their ratings only after significant damage to the market and to communities across the country. Though the proposed amendment takes steps to prevent such abuse in the future, rating agencies must be held accountable for their role in the current mortgage crisis. **NCRC recommends that civil penalties and equitable relief are necessary to address violations of the law. Credit rating agencies that engaged in unfair, coercive, or abusive practices should be subject to license suspension and penalties. Pursuant to the Sarbanes-Oxley Act, civil penalties and profits disgorgement should also be sought from credit rating agencies that issued inaccurate and inflated ratings, so that injury to communities, not only injury to investors, can be redressed.**

NCRC supports the SEC's proposed amendment to prohibit an NRSRO from rating a product where the NRSRO or a person associated with that NRSRO made recommendations about its structure. NCRC also supports the SEC proposed amendment to prohibit anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it. Additionally, NCRC supports the Commission's proposed amendment to prohibit gifts in any amount over $25 from those who receive ratings to those who rate them. However, it is clear that rating agencies were unduly influenced by those paying for the ratings to give unwarranted ratings to structured products contributing to the current mortgage crisis. These additional measures do not go far enough to address the inherent conflict of interest in the issuer/underwriter pays model. **Thus, NCRC recommends that the SEC work with rating agencies to adopt a fee-for-service structure, where rating agencies are compensated regardless of whether an issuer selects them to rate a structured product consistent with the rating agencies' recent agreement with the New York Attorney General.**

[3] Christopher Cox, Securities & Exchange Commission Chairman,Testimony Before the Banking, Housing, and Urban Affairs Senate Committee, April 22, 2008

NCRC supports the SEC proposed amendment to require credit rating agencies to make all of their ratings and subsequent rating actions publicly available. NCRC also supports the SEC's proposed amendment to publish performance statistics for one, three, and ten years within each rating category. NRSRO's should also be required to make an annual report of the number of rating actions they took in each ratings class and an XBRL database of all rating actions should be maintained on each NRSRO's website. Since public disclosure is a necessary step in promoting transparency and accountability, **NCRC recommends that a shorter three-month delay before publicly disclosing a rating action is sufficiently long to address business considerations under the proposed amendment to Rule 17g-2(d).**

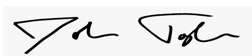
NCRC supports the SEC's proposed amendment requiring disclosure by the NRSROs of whether and how information about verification performed on the underlying assets of a structured product are relied on in determining credit ratings. **NCRC recommends that the SEC expand its proposed amendment to Rule 17g-5 to also require the disclosure of the results of any steps taken by the NRSRO, issuer or underwriter to verify information about the asset underlying or referenced by a structured finance product. Additionally, NCRC recommends that rating agencies require a series of representations and warranties from financially responsible parties about the loans underlying the structured product.**

NCRC supports the SEC's proposed amendment requiring documentation of the rationale for any material difference between the rating implied by a qualitative model that is a "substantial component" of the rating process and the final rating issued. NCRC also supports disclosure of how frequently credit ratings are reviewed; whether different models are used for ratings surveillance than for initial ratings; and whether changes made to models are applied retroactively to existing ratings. As noted in The New York Times by a former Moody's securitization expert, "Every agency has a model available to bankers that allows them to run the numbers until they get something they like and send it in for a rating."[4] **Therefore, NCRC recommends ongoing testing of the credit rating agencies to insure that they are using standardized methodologies.**

Generally, NCRC supports the proposed rules as necessary first steps to address the current mortgage crisis, caused in part by inflated and inaccurate credit ratings. However, NCRC urges the SEC to strengthen its proposal to include more due diligence requirements and ongoing testing of the NRSROs.

If you have any questions, please feel free to contact me at (202) 628-8866 or David Berenbaum, Executive Vice-President at (202) 464-2702.

Sincerely,



John Taylor
President and CEO
National Community Reinvestment Coalition

[4] New York Times, "Triple-A Failure", Roger Lowenstein, April 27, 2008.

The National Community Reinvestment Coalition (NCRC) is a non-profit association comprising more than 600 community-based organizations that promote access to basic banking services, including credit and savings, to create and sustain affordable housing, job development and vibrant communities for America's working families. Our members include community reinvestment organizations, community development corporations, local and state government agencies, faith-based institutions, community organizing and civil rights groups, minority and women-owned business associations, and local and social service providers from across the nation.

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April 7, 2008

Christopher Cox
Chairman
Securities and Exchange Commission
100 F St NE
Washington, D.C. 20549

Dear Chairman Cox:

We represent the National Community Reinvestment Coalition ("NCRC"), which is an association of more than 600 community-based organizations that promote access to basic banking services, including credit and savings, to create and sustain affordable housing, job development, and vibrant communities for America's working families. The NCRC has and continues to be a voice for communities around the country damaged by the aggressive expansion and subsequent implosion of the residential mortgage-backed securities ("RMBS") market. The NCRC is concerned that nationally recognized statistical rating organizations ("NRSROs"), more commonly known as credit rating agencies ("CRAs"), substantially contributed to the housing and foreclosure crisis by making public misrepresentations about the soundness and reliability of RMBS ratings. NCRC believes the NRSROs rating system failure has harmed the communities served by the NCRC because it fueled imprudent mortgage lending and irresponsible secondary market purchases of RMBS, which, in turn, contributed to high default and foreclosure rates. In reaction to this market turmoil, access to credit is now severely restricted in these same communities.

By this letter, the NCRC asks the SEC to thoroughly investigate the NRSROs, in particular Fitch, Inc. ("Fitch"), Moody's Investors Service, Inc. ("Moody's") and the Standard and Poor's Division of the McGraw Hill Companies, Inc. ("S&P"), because these institutions gave ratings to RMBS that were unwarranted given information that was known or available at the time of the rating and should have been considered under these NRSROs' own procedures. It is NCRC's position that Fitch, Moody's and S&P dominate the ratings market and all had or should have had access to loan files, underwriting standards and loan product information so that they could each conduct their own due diligence for fraud and/or poor underwriting. All three NRSROs acknowledged they did not review this information:

Fitch: In a November 28, 2007 report entitled *The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance* ("Fitch Report"), Fitch determined that based upon a review of a loan sample from one of the RMBS pools it had previously rated, "poor underwriting and fraud may account for as much as one-quarter of the underperformance of recent vintage RMBS." Fitch Report at 2. Fitch had not previously identified the high levels of fraud and poor underwriting in the pools it rated and represented that it would "utilize the insights from its review to improve the RMBS rating process." *Id.* (Copy of Fitch Report attached).

Moody's: In a March 25, 2008 report entitled *A Short Guide to Subprime* ("Moody's Report"), Moody's acknowledged that there were "indications of a decline in subprime loan standards in the years leading up to the present crisis," but that Moody's did not "anticipate the magnitude of delinquencies and losses on the underlying loans." Moody's Report at 2-3. As a result, Moody's has "updated its methodology for rating subprime RMBS to account for this unexpectedly poor loan performance." *Id.* at 3. Among the updates, Moody's noted its recent increased risk assumptions for high risk loan products, including loans with low or no documents and high loan-to-value (LTV) and combined loan-to-value (CLTV) loans. *Id.* (Copy of Moody's report attached).

S&P: In a February 7, 2008 report entitled *S&P Steps to Further Manage Potential Conflicts of Interest, Strengthen the Ratings Process, and Better Serve the Markets* ("S&P Report"), S&P represented it would "implement procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities." S& P Report at 2. (Copy of S&P Report attached).

These admissions by Fitch, Moody's and S&P demonstrate that these NRSROs did not consider information that was crucial to ensure the accuracy and integrity of ratings which they had represented to the public were reliable.

The SEC as well has recognized the impact of the flawed NRSRO rating system on the RMBS market. In your September 26, 2007 testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, you stated that the NRSROs underestimated the incidence of mortgage delinquencies in 2006 and noted that the NRSROs had identified several factors for their flawed ratings. These factors, including fraud in the mortgage origination process and deterioration in loan underwriting standards, were well known as credit risks long before the NRSROs began large-scale downgrades of their ratings in the second half of 2007. More recently, as a member of the President's Working Group on Financial Markets ("PWG"), you, along with the Secretary of the Treasury, and the Chairmen of the Federal Reserve Board and the Commodity Futures Trading Commission, jointly concluded in a March 13, 2008 Policy Statement (the "PWG Policy Statement") that one of the principal underlying causes of the turmoil in financial markets was "flaws in credit rating agencies' assessments of subprime residential mortgage-backed securities (RMBS) and other complex credit products…." PWG Policy Statement at 1. The PWG found that the turmoil was triggered by a "dramatic weakening of underwriting standards for U.S. subprime mortgages, beginning in 2004 and extending into early 2007." The PWG also found that "[f]aulty assumptions underlying rating methodologies and the subsequent re-evaluations by the credit rating agencies (CRAs) led to a significant number of downgrades of subprime RMBS, even of recently issued securities." *Id.* at 2.

As the agency charged with oversight of the NRSROs, the SEC is responsible for ensuring that a flawed rating system does not continue to harm investors and the public interest. In the preamble to the Credit Rating Agency Reform Act of 2006 (the "Act"), Congress stated that the purpose of the Act was "to improve ratings quality for the protection of investors in the public interest by fostering accountability, transparency, and competition in the credit rating industry." The SEC has the authority to determine whether the NRSROs' credit ratings were or are "in material contravention" of their procedures. 15 U.S.C. § 78o-7(c). The NRSROs publicly represented between 2004 and late 2007 that they had procedures in place to ensure that their RMBS ratings were accurate and sound. As even the PWG concluded, they were not. The SEC also has authority, as you testified on September 26, 2007, to determine whether the NRSROs were "unduly influenced by issuers and underwriters of RMBS to divert from their stated methodologies and procedures for determining credit ratings in order to publish a higher rating." The NCRC believes that a rating system that allows the NRSROs to be paid by the same institutions issuing the RMBS ensures a conflict of interest.

In your September 26, 2007 testimony, you confirmed that the SEC is conducting a non-public examination of the NRSROs as part of its licensing authority. The NCRC believes that much more is needed to fix the broken ratings system. To promote the purpose of the Act to foster accountability, transparency and competition in the credit rating agency, the NCRC asks the SEC to investigate Fitch, Moody's and S&P and the other NRSROs currently licensed by the SEC to determine whether:

1) they materially diverted from their standards, or committed a fraud on the market, by misrepresenting that they had sound and accurate procedures in place to accurately rate RMBS;

2) their failure to consider mortgage fraud, decreasing underwriting standards and high-risk loan products was a material diversion from their standards, or a fraud on the market; and/or

3) they were unduly influenced by issuers and/or underwriters to give unwarranted ratings to RMBS.

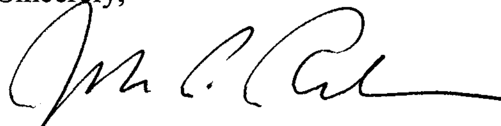
Based on this investigation, the SEC should release the aggregate results so that the public, and the lending and investment communities can better understand the NRSRO process and any shortcomings that need to be corrected. At the same time, the SEC should use its statutory authority under the Act to censure, deny or suspend registration of any NRSRO that has not complied with the Act, or any other statute enforced by the SEC. 15 U.S.C. § 78o-7(d). The SEC should suspend the license of any NRSRO that cannot demonstrate that it is following its own procedures and is reviewing information necessary to ensure that a rating is accurate and reliable. Further, the SEC should impose civil penalties and seek appropriate equitable relief where appropriate to address NRSRO violations of the Act, and any other statute enforced by the SEC. The SEC should also collaborate with the federal banking agencies and the FTC to ensure that consumers receive appropriate redress for the harms created as a result of imprudent loan origination and securitization.

The NCRC also asks that the SEC issue additional rules as required by the Act that clearly define acts or practices by NRSROs that are unfair, coercive or abusive. 15 U.S.C. § 78o-7(i). The SEC should consult with not only the RMBS issuers, lenders, servicers and investors, but with members of the advocacy community, including the NCRC, to assist in this process. The rules should, at a minimum, prohibit the NRSROs from rating RMBS without adequately evaluating the level of fraud, the sufficiency of underwriting standards and concentration of high-risk products in an RMBS pool. The

SEC should also require that the NRSROs maintain and provide documents to the SEC sufficient to demonstrate that they have adequately considered fraud, underwriting standards and concentration of high-risk products as a part of their rating. 15 U.S.C. § 78o-7(a)(1)(B)(x).

The NCRC looks forward to working with the SEC on these issues. By working together, the SEC and the NCRC can not only ensure that the purpose of the Act is fulfilled, but that communities across the country will be better served by the credit rating system. We will be contacting your office to set up a meeting to discuss the NCRC's concerns.

Sincerely,



John P. Relman
Bradley H. Blower
Counsel to the NCRC

Enclosures

Cc: John Taylor, President and CEO, NCRC
David Berenbaum, Executive Vice President, NCRC

US Residential Mortgage
Special Report

The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance

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Related Research
- "Drivers of 2006 Subprime Vintage Performance," dated Nov. 13, 2007.
- "Resilogic: US Residential Mortgage Loss Model — Amended," dated Aug. 14, 2007.

November 28, 2007

Summary

Residential mortgage-backed securities (RMBS) issued in 2006 and 2007, backed by pools of subprime mortgages, are substantially underperforming initial performance expectations, resulting in ratings downgrades and heightened risk of principal loss. As anticipated in Fitch's rating criteria, falling home prices are a fundamental source of poor performance. However, the 2006 subprime vintage performance is remarkable for the magnitude of early mortgage defaults. Fitch attributes a significant portion of this early default performance to the rapid growth in high-risk "affordability" features in subprime mortgages. The interaction of home price declines and high risk products in 2006 vintage subprime performance is analyzed in Fitch's special report "Drivers of 2006 Subprime Vintage Performance," dated Nov. 13, 2007. In addition to the inherent risk of these products, evidence is mounting that in many instances these risks were not controlled through sound underwriting practices. Moreover, in the absence of effective underwriting, products such as "no money down" and "stated income" mortgages appear to have become vehicles for misrepresentation or fraud by participants throughout the origination process.

Fitch believes that much of the poor underwriting and fraud associated with the increases in affordability products was masked by the ability of the borrower to refinance or quickly re-sell the property prior to the loan defaulting, due to rapidly rising home prices. With home prices now falling in many regions of the country, many loans that would have paid off in prior years remain in the pool and are more likely to default. BasePoint Analytics LLC, a recognized fraud analytics and consulting firm, analyzed over 3 million loans originated between 1997 and 2006 (the majority being 2005–2006 vintage), including 16,000 examples of non-performing loans that had evidence of fraudulent misrepresentation in the original applications. Their research found that as much as 70% of early payment default loans contained fraud misrepresentations on the application.[1] For additional information on measuring fraud within the industry, refer to Appendix A on page 9.

As Fitch sought to explain the poor performance of this vintage, we examined the impact of high risk collateral characteristics and rapidly declining home values. The underperformance was not fully explained by these factors, suggesting that other factors such as fraud might be playing a significant role. This was supported by the results of a file review conducted by Fitch on a small sample (45 loans) of early defaults from 2006 Fitch-rated subprime RMBS, many of which had apparently strong credit characteristics such as high FICOs, as outlined in the Characterics table on page 2.

Fitch's review of these files indicated that these loans suffered in many instances from poor lending decisions and misrepresentations by borrowers, brokers and other parties in the origination process. High risk products, which require sound underwriting and which are easy targets for fraud, account for some of the largest variances to expected default rates. It is not possible to confidently make a broad statement of how pervasive these problems are across the range of originators and issuers in Fitch's rated portfolio based on such a small sample of loans. However, given the combination of our review of historical loan performance, the pervasive problems indicated in the file review, and the findings of third-party reviews, Fitch believes that poor underwriting quality and fraud may account for as much as one-quarter of the underperformance of recent vintage subprime RMBS.

Characteristics of Small File Sample

# of Loans	45
Average FICO	686
Average Combined LTV Ratio	93
% California Properties	49
% Low/No Doc	69
% 2nd Lien	60

LTV – Loan-to-value. Source: Fitch.

In order to better understand the nature and impact of poor underwriting and fraud on subprime RMBS performance, Fitch analyzed a targeted sample of early defaults from 2006 Fitch-rated subprime RMBS. Fitch's findings from this review include:

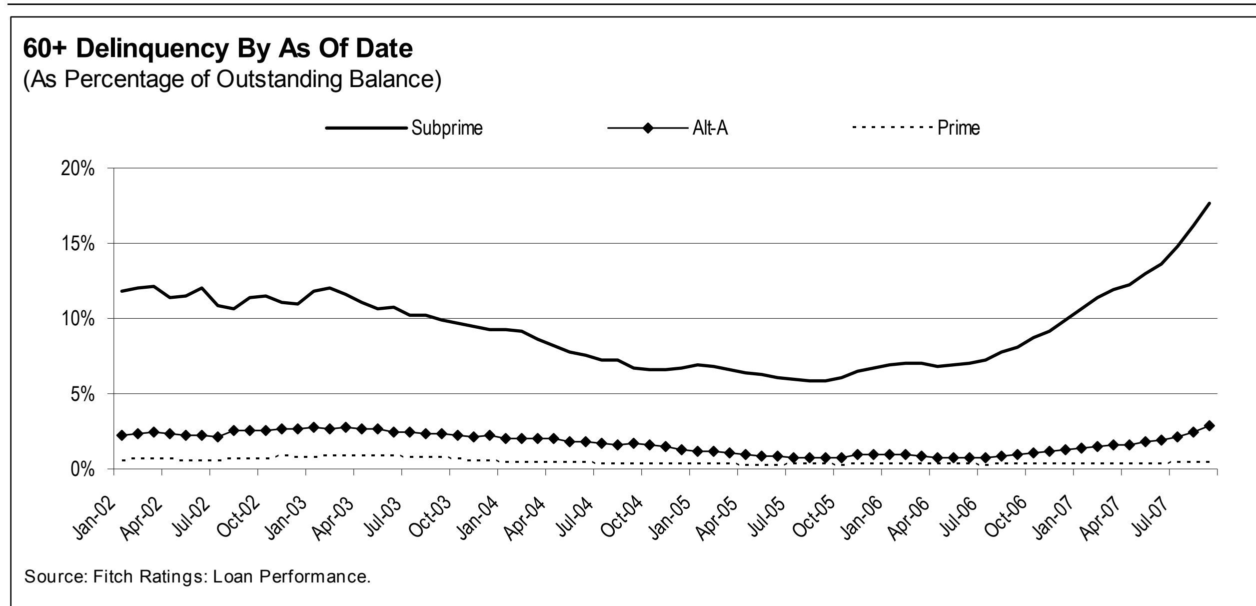
- Apparent fraud in the form of "occupancy misrepresentation." The borrower's stated intent was to occupy the property, but there is evidence in the loan files that this did not occur, and that it is likely that occupancy was never the true intent of the borrower.
- Poor or lack of underwriting relating to suspicious items on credit reports. The loan files of borrowers with very high FICO scores showed little evidence of a sound credit history but rather the borrowers appeared as "authorized" users of someone else's credit.
- Incorrect calculation of debt-to-income ratios.
- Poor underwriting of "stated" income loans for reasonability of the indicated income.
- Substantial numbers of first-time homebuyers with questionable credit/income.
- In one instance, acknowledgement by the borrower of being the "straw buyer" in a property flipping scheme.

Fitch recognizes that, even in good quality pools, there will be some loans that default. However, when some pools of subprime mortgages have very high projected default rates, it is important to understand the impact that loans originated with poor underwriting practices and fraud can have. Moreover, Fitch intends to utilize the insights from its review to improve the RMBS rating process. Fitch believes that conducting a more extensive originator review process, including incorporating a direct review by Fitch of mortgage origination files, can enhance the accuracy of ratings and mitigate risk to RMBS investors. Fitch will be publishing its proposed criteria enhancements shortly. Additionally, a more robust system of representation and warranty repurchases may be desirable.

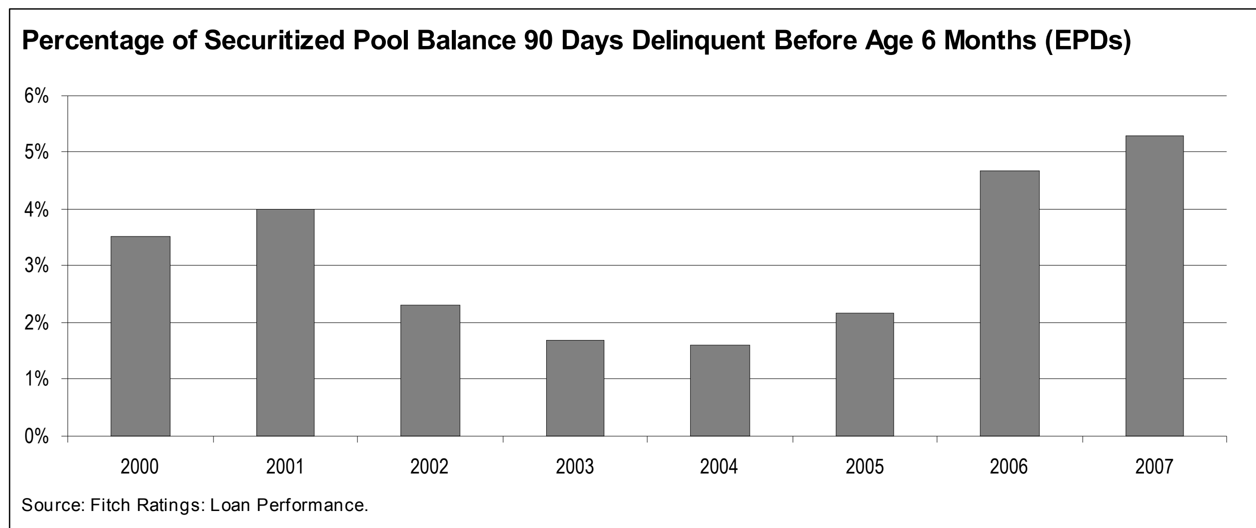
In order to better detect and prevent poor underwriting and fraud, a combination of technology and basic risk management is needed before, during and after the origination of the loan. In this report, Fitch discusses some of the more obvious examples of evidence of fraud found in loan files, along with some of the steps that could identify the fraud at the earliest possible stage, ideally before the loan is funded. There are several effective fraud indication tools available today to the originator/issuer and servicer; however, it is important to acknowledge that no process or tool can identify all instances of misrepresentation or fraud.

■ Lack of Disciplined Underwriting Increases Defaults and Allows Fraud

Increased risk caused by operational weaknesses oftentimes is not apparent in the collateral characteristics, but rather, manifests itself in the pool performance. As detailed in Fitch's criteria report, "ResiLogic: US Residential Mortgage Loss Model — Amended" dated Aug. 14, 2007, Fitch derives base frequency of foreclosure and loss severity, and therefore expected base case loss amounts, using each loan's disclosed risk attributes. These attributes include loan-to-value (LTV), combined loan-to-value (CLTV) and FICO scores, which are historically the primary drivers of default risk, with loan purpose and occupancy as secondary drivers of default risk. However, additional risk caused by inaccurate data and/or fraudulent or misrepresented factors could materially affect the performance of



Source: Fitch Ratings: Loan Performance.



Source: Fitch Ratings: Loan Performance.

pools. Losses are more likely to be low if the originator consistently applies underwriting policies and guidelines, and has adequate quality control procedures, sufficient technology, and/or has risk management processes that are well developed and applied. For example, an inadequate appraisal quality review program is a significant risk factor since the valuation determines LTV. In most cases, the lack of an appropriate valuation at origination may not be evident until the borrower defaults on the loan or attempts to sell/refinance the property.

There is a distinction between inaccurate data provided by the originator/issuer to investors, and others who rely on the data, including Fitch, and data, which is technically accurate, but does not actually reflect the true credit risk due to poor underwriting, quality control, or property valuation. Fitch believes that data, which is correct but inaccurately reflects the credit risk (e.g., stated income was not reasonable), is a larger component of underperformance than data integrity issues (e.g., debt-to-income ratios [DTI] were incorrectly stated on tape). Therefore, increasing data reverification on securitized transactions, while potentially beneficial, will not address the more material risk and will result in increased costs and reduced efficiencies for consumers and securitizations. Fitch believes that the rating agencies could add value by assessing the rigor and integrity of underwriting and valuation processes and controls, as part of their originator/issuer reviews.

There has been a significant increase in the defaults and EPDs in 2006 and 2007 vintage subprime securitizations as outlined in the two charts on page 3. In Fitch's research to determine the causes for high defaults in recent vintage pools, several factors began to emerge which indicated that the underlying loans did not perform consistently with their reported risk characteristics. To gain a better understanding of the situation, Fitch selected a sample of 45 subprime loans, targeting high CLTV, stated documentation loans, including many with early missed payments. In particular, we selected loans that were primarily purchase transactions having a higher range of FICO scores (650 to 770), because high FICO scores and purchase transactions are historically attributes which generally reduce the risk of default. Fitch's analysts conducted an independent analysis of these files with the benefit of the full origination and servicing files. The result of the analysis was disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file.

While we realize this was a very limited sample, Fitch believes that the findings are indicative of the types and magnitude of issues, such as poor underwriting and fraud, which are prevalent in the high delinquencies of recent subprime vintages. In addition, although the sample was adversely selected based on payment patterns and high risk factors, the files indicated that fraud was not only present, but, in most cases, could have been identified with adequate underwriting, quality control and fraud prevention tools prior to the loan funding. Fitch believes that this targeted sampling of files was sufficient to determine that inadequate underwriting controls and, therefore, fraud is a factor in the defaults and losses on recent vintage pools. Additionally, Fitch continues to attempt to expand its loan sample to provide further validation of its findings and will provide additional commentary as applicable.

In light of our findings, Fitch believes that it is important to reassess the risk management processes of originators and/or issuers for product being securitized going forward.

While prime originators are not immune to fraud schemes, the subprime sector has exhibited the most vulnerability to them. Undoubtedly, flat or declining home prices and the loosening of program guidelines remain the main drivers of defaults and therefore losses within the subprime sector. However, Fitch believes that poor underwriting processes did not identify and prevent and, therefore, in effect, allowed willful misrepresentation by parties to the transactions, which has exacerbated the effects of declining home prices and lax program guidelines. For example, for an origination program that relies on owner occupancy to offset other risk factors, a borrower fraudulently stating its intent to occupy will dramatically alter the probability of the loan defaulting. When this scenario happens with a borrower who purchased the property as a short-term investment, based on the anticipation that the value would increase, the layering of risk is greatly multiplied. If the same borrower also misrepresented his income, and cannot afford to pay the loan unless he successfully sells the property, the loan will almost certainly default and result in a loss, as there is no type of loss mitigation, including modification, which can rectify these issues.

■ Research Results

The files reviewed by Fitch's analysts contained common features that Fitch believes contributed to default on these loans. Although the loan programs under which these loans were underwritten allowed for several high risk features, the files indicated a lack of underwriting review for basic reasonableness and credibility. It is important to note that while most of these issues could have been noted and investigated at the time of origination, others, such as occupancy and property condition, only became obvious as the servicer performed its functions.

Some general examples of these findings are below.

- Borrower balance sheet and assets did not support income as stated
  - No indication in file of reasonableness test or attempt to obtain additional information.
  - Some verbal employment checks provided by borrower (self-employed) or related individual (spouse).
- DTI ranged from 44%–57%
  - Some exceptions were made to programs, but for many the amounts used for calculation did not include other debts and/or tax/insurance/homeowners' association (HOA) dues which could have been determined from information within the files.
- Credit Reports

  - FICO scores based on "authorized" accounts or joint accounts, where the borrower is utilizing someone else's credit.
  - No notation as to research on fraud or other alerts shown on credit reports.
  - No notation as to research on inconsistent social security numbers, date or birth, or AKAs from application to credit reports.
  - No research in the files on reported unresolved derogatory credit, including judgments, liens, etc.
- Seller concessions and other closing items
  - No indication of review performed on HUD-1 Settlement Statement for consistency with contract in file, allowable amounts paid for borrower, or funds to borrower (including purchase transactions).
  - No indication in file of review of borrower identification or signature.
- No consideration for payment shock, NSFs, or overdrafts
  - No indication in file of review of borrower's ability to sustain materially higher payments (assets or deposits did not indicate borrower had excess liquidity).
  - No notation as to research on NSFs, or overdrafts shown in bank statements.
- Incomplete documentation
  - Occupancy form signed by borrower but box declaring occupancy rarely checked.
  - Missing "final" version of closing documents.

Characteristics by percentage of the 45 files reviewed included (loans may appear in more than one finding):

66%	Occupancy fraud (stated owner occupied — never occupied), based on information provided by borrower or field inspector
51%	Property value or condition issues — Materially different from original appraisal, or original appraisal contained conflicting information or items outside of typically accepted parameters
48%	First Time Homebuyer — Some applications indicated no other property, but credit report showed mortgage information
44%	Payment Shock (defined as greater than 100% increase) — Some greater than 200% increase
44%	Questionable stated income or employment — Often in conflict with information on credit report and indicated to be outside "reasonableness" test
22%	Hawk Alert — Fraud alert noted on credit report
18%	Credit Report — Questionable ownership of accounts (name or social security numbers do not match)
17%	Seller Concessions (outside allowed parameters)
16%	Credit Report — Based on "authorized" user accounts
16%	Strawbuyer/Flip scheme indicated based on evidence in servicing file
16%	Identity theft indicated
10%	Signature fraud indicated
6%	Non-arms length transaction indicated

Fraud has grown significantly over the past few years in volume and complexity. Fitch believes that there are many things that originators/issuers could do to prevent misrepresentation and fraud, as discussed below.

Originator's/Issuer's Role in Identifying Fraud and High Risk Loans

As the mortgage lending industry continues to make the mortgage process faster and less expensive, the occurrences of fraud continue to grow. For example, advances in personal computer capabilities enable individuals to produce documents to support fraudulent data, which are often hard to distinguish from true originals. In addition, access to databases has enabled perpetrators to alter pertinent loan documentation and information or create falsified loans where there is no borrower or property.

In many instances, misrepresentations and altered documentation are evident in the physical files, and most lenders provide underwriters and other personnel with training to identify red flags that may indicate fraud. Many lenders have an individual or group to research and resolve situations where fraud is suspected. Often, loans containing misrepresentations have multiple problems that can be detected through a strong validation and reverification process.

Mortgage fraud has increased in recent years to an extent that The Federal Bureau of Investigation (FBI) has reported the cost to the mortgage lending industry is between $946 million and $4.3 billion in 2006 alone.[2] Because fraud is becoming so prevalent, Fitch expects lenders to aggressively monitor for fraud, research and resolve suspected cases, and take appropriate actions against the source(s) of the problem. This includes the repurchase of loans by third parties, the removal of these parties from further business dealings, the dismissal of employees involved and, where appropriate, legal action.

Some of the primary areas of mortgage fraud are discussed below, along with the originators' actions which could identity these situations. It is important to keep in mind that for several of the situations mentioned here, there are widely available tools that can be purchased which increase the originators' ability to quickly identify potential problem loans.

Broker-Originated Loans

Broker-originated loans have consistently shown a higher occurrence of misrepresentation and fraud than direct or retail origination. In most instances, the broker will be the only direct contact with the borrower, and often is in the position of gathering most, if not all, required information on the borrower, including in some cases the selection of the appraiser. In this role, they have the ability, if inclined, to adjust or amend the stated facts, with or without the borrower's knowledge, to allow the loan request to fit within the parameters of lender guidelines.

Certainly not all brokers would engage in these activities; however, it is imperative that lenders actively research the identity and history of individuals applying for inclusion in lending programs, as well as maintain a regular update on all brokers. Lenders are expected to actively monitor the approval/reject record, repeat/amended submissions, and performance/default record for loans from each broker. In addition, if problems are detected, the lender is expected to aggressively research the cause, and if misrepresentation or fraud is indicated, to withdraw the broker's approval and, if appropriate, pursue legal actions. Finally, to prevent a repeat of this activity, the lender can provide the broker's name and identification information to The Mortgage Banker's Association's (MBA) Mortgage Asset Research Institute (MARI), which maintains a list of reported brokers that may be accessed by other lenders.

Stated Income

Stated income programs were initially reserved for high net worth individuals, who were self-employed and did not want to disclose all their business dealings but had assets that supported the income stated and strong credit profiles and credit scores. As the mortgage industry grew, originators expanded their programs to include salaried borrowers, and then on to the subprime sector.

Lenders who use reasonableness tests for income during the underwriting process, as well as initiate further research if the stated amounts appear inflated, can mitigate the risk inherent in stated income products. If the borrower profile does not support the income levels indicated, either by assets or liquidity (bank or savings accounts), the reasonable assumption would be that the income could be inflated. In addition, if lender guidelines require a verbal statement of employment, care should be exercised to determine that the individual providing the statement is an unrelated, independent source.

Originators often use the Internet to help confirm employment and the reasonableness of the income based on job title and geographic location. Most lenders know and have the ability to use the various sites and programs which provide this type of "reasonableness" check, and when stated income falls outside these parameters by an established variance, further research would be warranted.

FICO Inflation

FICOs present a consistent statistical assessment of the borrower's creditworthiness and risk profile; however, credit scoring is limited by the accuracy of the data contained within the credit bureau file. The confidence that originators place in FICOs may be diminished, and the perceived risk of the loan may be altered, when information provided within the report is not taken into consideration. Therefore, if the credit report provides conflicting information regarding Social Security Numbers, birth dates, addresses, indications of the use of multiple names, fraud alerts (known as HAWK Alert), etc., the lender should perform additional research.

Another concern with FICO score accuracy involves companies, typically Internet-based, who sell a means to artificially inflate a borrower's FICO. It has been estimated, as well as claimed by these services, that the use of a single "borrowed" account from a good consumer, reflected on the credit report as an "authorized user" account, will increase a FICO score by 50 to 75 points. Multiple authorized user accounts have the possibility of inflating a poor credit borrower's FICO by as much as 200 points. While this practice is not technically illegal for the service provider, many feel that the borrower who utilizes another person's good credit to inflate their score for the purpose of misleading a lender is committing fraud.

However, the industry is starting to limit the use of authorized user accounts or "piggyback credit." For example, Fair Isaac Corp. indicated that it was taking steps to ensure credit scores are not artificially enhanced by using borrowed credit by modifying the formula for its FICO score. The newest FICO model (version FICO 08) will ignore authorized user accounts. In addition, TransUnion LLC expanded its offerings to help the financial industry by identifying consumers who may have added authorized user relationships to their credit files to artificially enhance their credit standing.

Because of the effect of authorized users and other credit "improvement" schemes available today, lenders who review all information on a proposed borrower's credit report will be able to better determine the full indication of a borrower's credit risk profile. Specifically, if a lender uses a "high" FICO as a compensating factor for layered risk or risk outside stated program guidelines, the need to determine the accuracy of this tool is materially increased.

Property Valuation Accuracy

Risks associated with appraisals are varied and costly. Based on the past unprecedented home price appreciation in some markets and recent regulatory investigations, there is widespread concern regarding the number and severity of inflated valuations used to determine LTV. The availability of stated value refinances, inappropriate use of alternative valuations, and high production volume pressures on appraisers contributed to this problem. The effect of flat or declining home values, currently evident on a national scale, is most sharply felt in some of the same markets affected by the most inflated valuations, making current assessments of appropriate valuations more difficult. As a result, lenders are expected to exercise additional caution when determining values, and therefore LTVs to use in their risk assessments.

Fitch believes that a comprehensive valuation program uses a combination of full appraisals, automated valuation models (AVMs), and review appraisals. AVMs can be used to check and verify the appropriate valuations of appraisals at a relatively low cost. They are especially useful in the selection of properties for re-appraisal or appraisal review as part of a comprehensive quality control program. In addition, most lenders have procedures for reviewing appraisals referred by underwriting or quality control that use either in-house certified review appraisers or adequately monitored third-party review appraisers.

Lack of Underwriting

The high volume of mortgage applications over the past few years, coupled with the consumer's demand for more rapid responses to those applications, led to use of automation via Automated Underwriting Systems (AUS) and the use of validators to ease heavy underwriter workload. The borrower application information, often provided by the broker, is typically subject only to a cursory validation process. The cost savings benefit of using less experienced employees must be offset by controls to mitigate the likelihood that critical data points or red flags that could materially affect the underwriting decision or pricing may be overlooked.

Policies should address how the lender is evaluating risk layering, disposable income and payment shock. In addition, compensating factors are often used to override or offset loan characteristics that do not meet stated program guidelines. However, typically a single compensating factor would not offset multiple layers of risk. Therefore, to determine acceptable and predictive levels of risk, exceptions, upgrades, and overrides to established underwriting and loan programs should be carefully documented, monitored and disclosed.

Audits and Quality Control

To mitigate and control the extensive risks associated with originations, a lender needs an active, dynamic, and systemic quality control and internal audit program. An independent quality control program can provide an objective assessment of credit risk and compliance to the company's loan product and underwriting guidelines, as well as identify deteriorating asset quality. Pre- and post-funding quality control programs assess the underwriting decision, re-verify documentation, and provide constructive feedback to management.

Representations and Warranties (Reps & Warranties) in RMBS

In RMBS transactions, reps and warranties are given by the originator, issuer or other appropriate party, covering several areas, including the legality of the mortgage loan, the lien status, and condition of the property. In addition, some of the reps and warranties address compliance with the originator's underwriting standards and a smaller number of transactions have specific reps and warranties for fraud. However, there are several challenges to relying on reps and warranties to remove loans from RMBS deals for a breach due to underwriting or misrepresentation/fraud.

For many subprime loans, the program guidelines allowed the originator to base qualification on features such as stated income. Assuming that the originator's underwriting standards did not require the verification through another means, or that a "reasonableness test" be conducted, the failure to perform these steps would not be an exception to their underwriting standards. Therefore, if the borrower or broker misrepresented the actual income, it is fraud on their part, but is it a breach of the reps and warranties? The same question would apply to borrowers who have artificially enhanced their FICO.

Most pooling and servicing agreements that Fitch reviewed indicate that any party to the transaction (typically, the issuer, servicer, master servicer, or trustee) who becomes aware of a suspected breach to the reps and warranties should provide notice to the trustee (or in some all other parties). However, unless there is a reason that research is conducted to specifically look for a breach, finding potential breach situations typically requires an awareness and identification by the servicer while conducting their functions. Directions as to the process after notification are somewhat varied, but in general, if a breach is determined, the trustee will facilitate the request for repurchase of the loan from the transaction. Fitch believes that risk management firms that track potential repurchase candidates and monitor the repurchase process can enhance the effectiveness of representations and warranties. However, in today's environment, one of the situations which could occur would be that the original provider of the reps and warranties is no longer in existence or has filed bankruptcy.

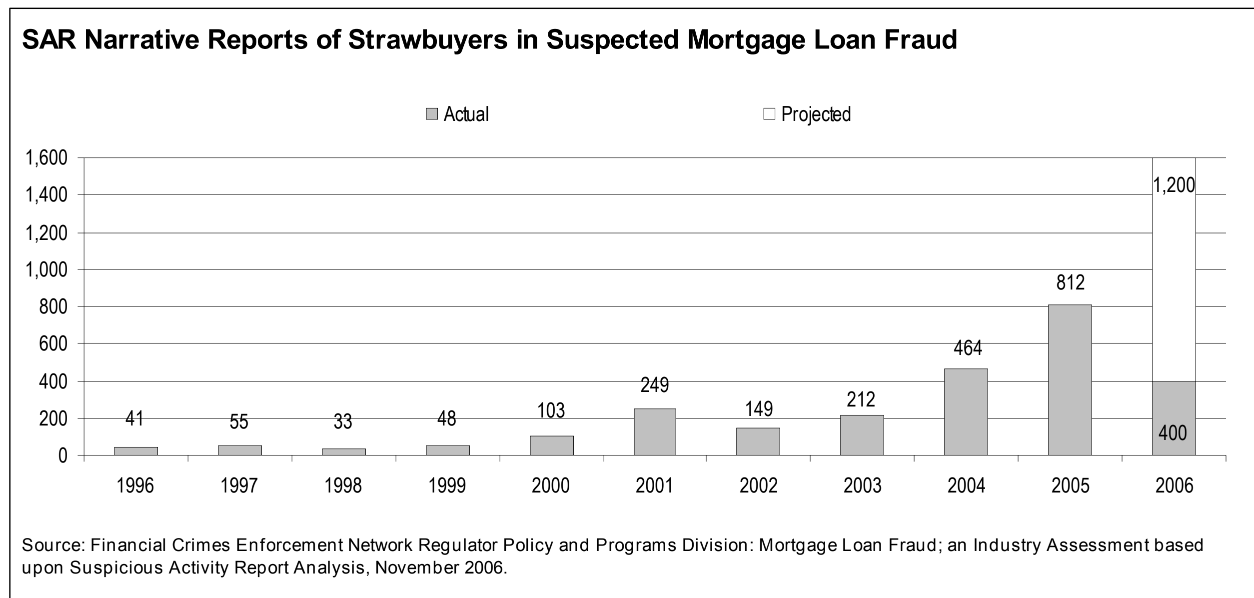
Appendix — Measuring Fraud Within the Industry

Difficulties in Measuring and Reporting Fraud

Although most information available today on mortgage fraud indicates a strong increase in the amount and complexity of fraud in the industry, there is not a clear mechanism in place today to adequately identity and track these instances.

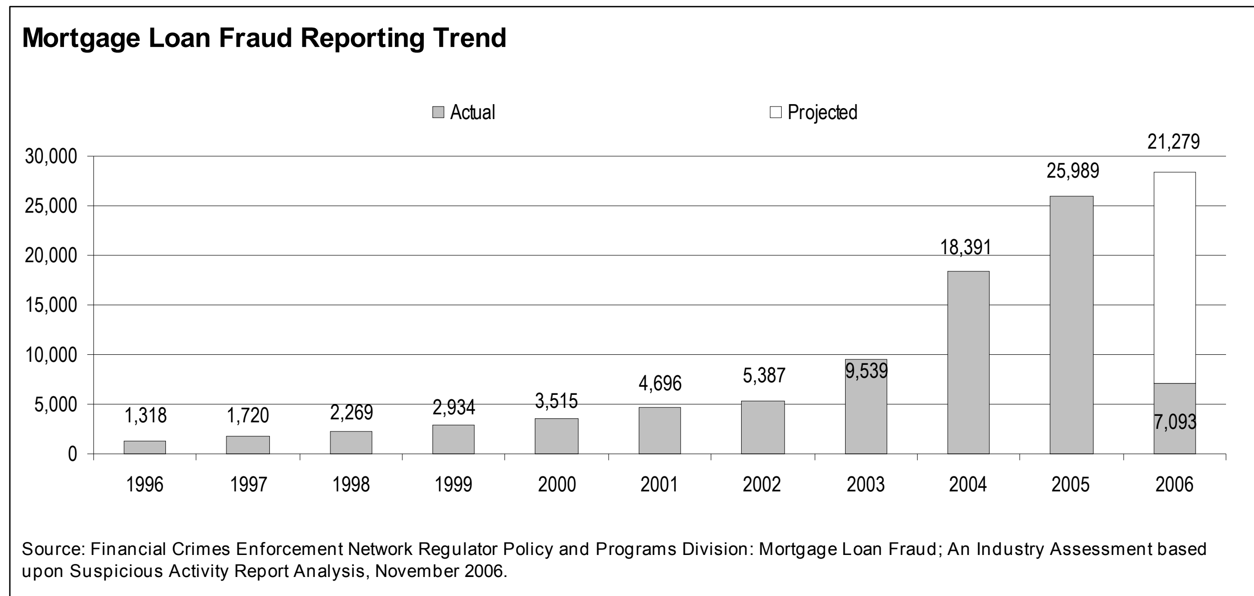
One source for this information is the US Department of the Treasury, Office of Inspector General's Financial Crimes Enforcement Network (FinCEN), which was established in 2001 to advise and make recommendations on matters relating to financial intelligence and criminal activities, including mortgage loan fraud. In the most recent Suspicious Activity Report (SAR) dated November 2006, the bureau reported a 14-fold rise in mortgage fraud-related suspicious activity reported between 1997 and 2005.[3] However, the first quarter of 2006 is the most recent data available currently.

SAR Narrative Reports of Strawbuyers in Suspected Mortgage Loan Fraud



Source: Financial Crimes Enforcement Network Regulator Policy and Programs Division: Mortgage Loan Fraud; an Industry Assessment based upon Suspicious Activity Report Analysis, November 2006.

Mortgage Loan Fraud Reporting Trend



Source: Financial Crimes Enforcement Network Regulator Policy and Programs Division: Mortgage Loan Fraud; An Industry Assessment based upon Suspicious Activity Report Analysis, November 2006.

It is important to realize that the SARa are typically only filed by federally chartered or federally insured institutions. Since the majority of the subprime mortgage loans are originated by entities that are not federally chartered or insured, the number of potential fraud instances could easily be multiplied two to three times.

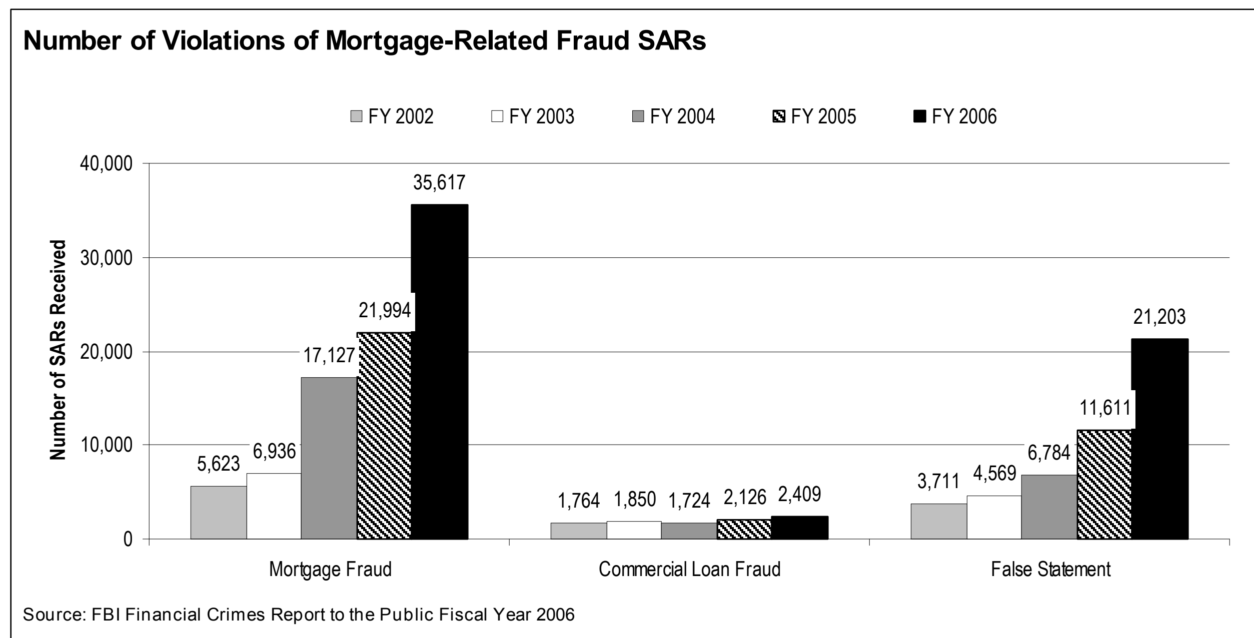
Another widely acknowledged source for mortgage fraud information, MARI provides an annual report on mortgage fraud activity. Although the MBA has access to a wider range of information from its membership, the information is provided as an index for the states and metropolitan areas, and without access to the raw data behind the indexes, comparison and trending is limited. However, MARI has indicated that its records show a 30% increase in loans with suspected mortgage fraud in 2006, with the most common type of fraud being employment history and claimed income. The report went on to show that while 55% of overall fraud incidents reported to MARI were application fraud, the percentage of subprime loans with application fraud was higher at 65%. In addition, for appraisal/valuation fraud the overall was 11%, with subprime at 14%. The report also makes a projection with regard to the cases of fraud in subprime, indicating that it will likely take three to five years to uncover most of the fraud and misrepresentation in the 2006 book of business.[4]

The FBI reports the actual number of convictions for mortgage fraud has increased 131% from 2001 to 2006. As shown in its report for 2006, the FBI investigated 818 cases and obtained 263 indictments and 204 convictions of mortgage fraud criminals. The agency also reports that in 2006, for mortgage fraud, it accomplished $388.9 million in restitutions, $1.4 million in recoveries, and $231 million in fines.[5]

However, the timing of reported fraud cases must be considered when attempting to determine the increasing trend of occurrence within the FBI numbers. While some fraud cases can be identified at the time of origination, most will not be noted until later in the servicing process. This may occur when the servicer notes a first or early payment default; a borrower cannot be contacted or traced; inspection of the property identifies vacancy, tenants, or conditions that are not as noted on the appraisal; or possibly when, during contact with the borrower or other parties in the transaction, there is an admission of misrepresentation. Also, with regard to the FBI reported convictions, it should be noted that there may be a considerable span of time from the identification and investigation phase of these cases to pending and final conviction. This delay, combined with the difficulty in identifying the vintage of loan origination, makes specific trending using this data complicated at best.

There are providers of advanced technology tools to identify fraud or misrepresentation available in the industry today. Some of these providers also report their findings in summary or on certain features of fraud. This

Number of Violations of Mortgage-Related Fraud SARs



Source: FBI Financial Crimes Report to the Public Fiscal Year 2006

information is helpful to the industry; however, the information provided by these vendors will be limited to the data provided to them from their clients. Notwithstanding this limitation, because these companies are typically actively looking for fraud in new production files, the statistics they provide may well be the most up to date information available upon which to monitor trends.

Endnotes

[1]White Paper, “Early Payment Default – Links to Fraud and Impact on Mortgage Lenders and Investment Banks,” 2007 BasePoint Analytics LLC.

[2]Federal Bureau of Investigation, “Mortgage Fraud: New Partnership to Combat Problem: March 9, 2007.”

[3]Mortgage Loan Fraud, An Industry Assessment based upon Suspicious Activity Report Analysis, November 2006, Financial Crimes Enforcement Network, Regulatory Polity and Programs Division, Office of Regulatory Analysis, US Department of the Treasury.

[4]Ninth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association, April 2007, Mortgage Asset Research Institute, LLC., a ChoicePoint Service.

[5]“Financial Crimes Report to the Public Fiscal Year 2006, October 1, 2005 – September 30, 2006,” Federal Bureau of Investigation.

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A Short Guide to Subprime

March 2008

www.moodys.com/subprime

Structured Finance in Focus *presents a quick, clear read on key structured finance topics.*

For the "fine print" on subjects discussed herein, or elsewhere, please see the additional resources and contacts listed at the back of this publication.

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Moody's Investors Service

The Subprime Decline – Putting it in Context

Subprime Residential Mortgages have become a focus of sharp attention in the wake of the unusually poor performance of subprime loans originated in 2006 and 2007 (the 2006 and 2007 "vintages").

Periodic declines in performance are not uncommon to the residential housing market, but the current downturn has been exacerbated by several key sequential factors:

- *From 2005 to early 2007 underwriting standards were exceptionally aggressive.*
- *In mid-2006 there began a pronounced and prolonged decline in home prices.*
- *Once the length and degree of the downturn became clear, the market responded with a rapid tightening of lending standards.*
- *Tightened standards made it difficult for subprime borrowers to re-finance, since they lacked the advantage of high home price appreciation that favored borrowers in earlier vintages.*

Before examining the particulars of these factors, it pays to place the subprime slump in a wider context.

The Rise Before the Fall – the Residential Housing Credit Cycle

The performance of subprime loans follows a pattern that is typical of the residential housing "credit cycle." During periods of growth in housing and mortgage markets, existing lenders expand their business and new lenders enter the market, eventually creating overcapacity. Then, as the mortgage market cools, competition among lenders heats up and they may lower credit standards (i.e., make riskier loans) to maintain origination volume.

Lending behavior in the subprime mortgage market followed this pattern in 2006, with lenders introducing alternative mortgage loans with easier terms – and greater risk of delinquency and default – including:

- *Loans for the full price of a home – i.e., no down payment, no equity.*
- *Loans with less thorough documentation verifying borrower's income and assets* ("No/Low Doc").
- *Loans with low initial "teaser" rates that expose borrowers to sudden payment increases* ("Hybrid ARMS").

Such subprime loans formed a steadily increasing proportion of total loan origination by dollar volume over the five years 2002 - 2006:

Year	Total Mortgage Origination	Total Subprime Origination	Subprime Origination as Percent of Total
	($ billions)		
2006	2,886	640	22%
2005	3,201	625	20%
2004	3,046	560	18%
2003	4,370	539	12%
2002	3,038	421	14%

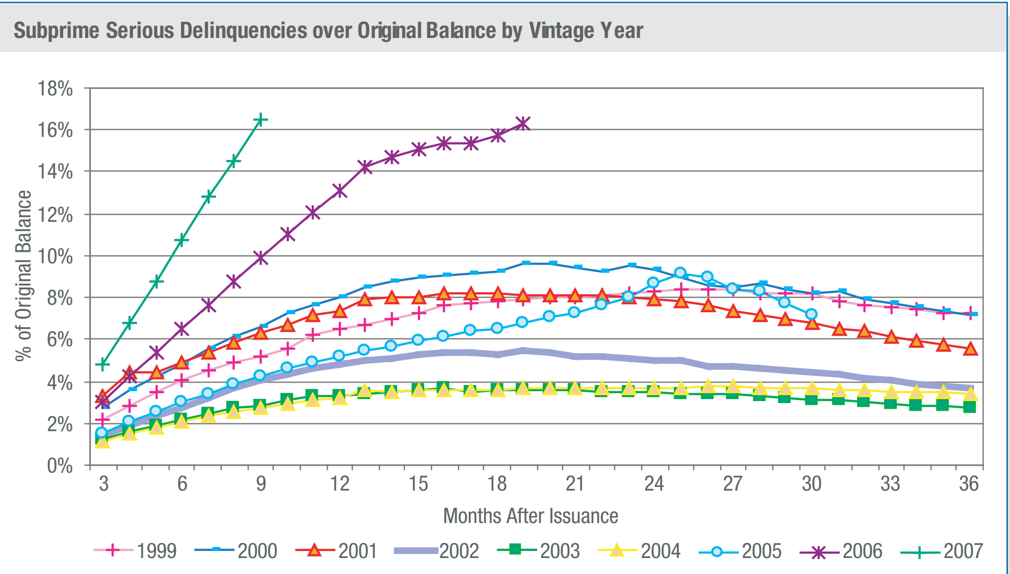
This marked rise in subprime loans as a percentage of total mortgage origination coincided with unusually poor performance in the 2006 vintage of subprime loans (see "Down Years for Subprime Loans," *page 2**). There has since been considerable concern among market participants about possible future losses in RMBS tranches backed by these loans.*

Down Years for Subprime Loans – *Why the 2006 and 2007 Vintages Soured*

The increased number of subprime loans extended, as mortgage originators loosened standards towards the end of the residential housing credit cycle, would certainly explain why delinquencies and defaults might rise in the overall mortgage market (prime and subprime). But it does not explain why the 2006 and 2007 vintages of subprime loans performed so poorly compared with previous years (see exhibit, below right).

A succession of factors played a significant role in exacerbating the situation:

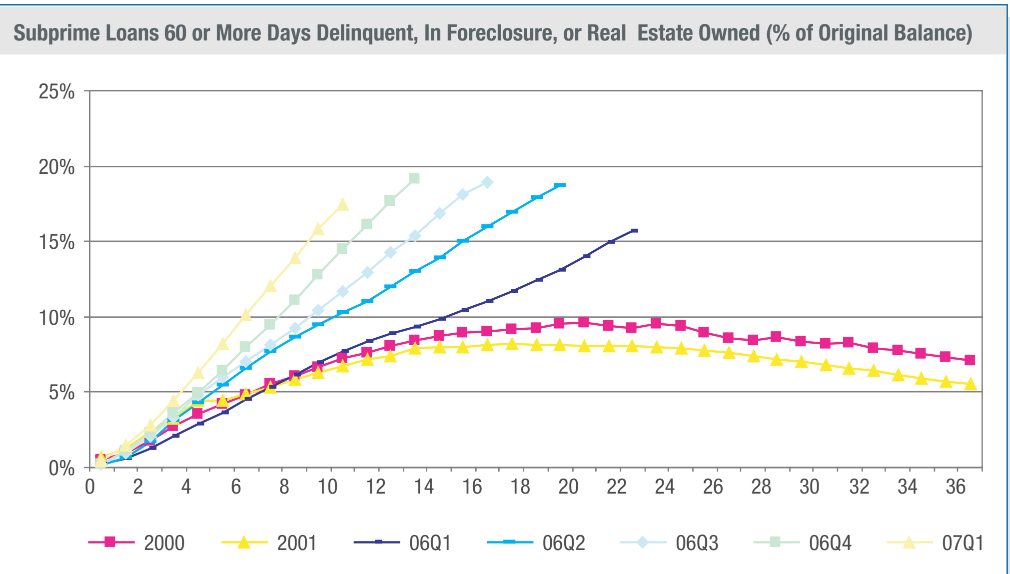
- **Aggressive Underwriting** – *including "risk layering" (i.e., mortgages with multiple risk factors).*
- ***Possible Misrepresentation*** *by brokers, appraisers, and/or borrowers.*
- **Decline in Home Prices Nationally** – *July 2007 marked the 12th consecutive month of year-over-year home-price declines nationally, the longest such period since 1969.*
- **Rapid Reversal in Mortgage Lending Standards** – *in response to the housing slump, mortgage-lending standards were tightened, quickly stranding over-stretched borrowers (including speculators) needing to refinance in the future.*



As the residential mortgage market shifted from an environment of aggressive lending, low interest rates, and rapid home-price appreciation from 2004 till early 2006 to one of tighter lending standards, higher borrowing costs, and a weak housing market, the performance of 2006 and 2007 vintage subprime loans and the mortgage-backed securities for which they were collateral deteriorated.

Subprime Timeline

Though there were indications of a decline in subprime loan standards in the years leading up to the present crisis, the initial delinquency data for the 2006 vintage of subprime loans was still largely in line with performance during the last US recession in 2000 and 2001. We did take discrete rating actions on individual securities as early as November 2006, but we did not anticipate the drastic rise in delinquencies that would occur throughout 2007 (figure, right). When significant deterioration did become apparent in the second quarter of 2007, Moody's took prompt, deliberate action, and the first comprehensive set of rating actions on 2006-vintage subprime-backed securities was taken in April 2007.



Moody's does not take wholesale rating actions based on market developments. Rather, our analysts carefully and deliberately consider the data that we receive on a transaction-by-transaction basis, carefully monitoring each security to make sure that all relevant information is considered. In this way, we insulate the analysis of individual securities from the influence of negative market sentiment. In addition, as more data becomes available, we continually reassess our loss expectations and adjust the estimated credit-protection needed to attain a given rating level. We communicate these changes to the market through our published rating methodologies and Special Comments.

Not Just a Problem of Problem Loans – the Role of RMBS in the Subprime Crisis

The subprime crisis is largely a product of increasingly aggressive mortgage loan underwriting standards adopted as competition to maintain origination volume intensified amid a cooling national housing market. But it is also, quite significantly, a crisis of confidence in the structured finance markets.

The structured finance market is still relatively new in comparison with the traditional bond markets (see box at right), and thus has not yet undergone a corrective shock of this magnitude. It has also been an incredibly fast-growing market — a long period of low interest rates, combined with new capital requirements under Basel II, provided a strong impetus for banks to move credit risk off of their balance sheets and to access capital markets through securitization structures, including residential mortgage backed securities (RMBS).

As more and more subprime RMBS instruments became available, market participants eagerly moved into such investments for their higher yields. Many loans underlying these securities, however, had multiple, "layered" risks and thus greatly under-performed initial expectations, with significant effects on subprime RMBS performance. There has also been a spillover effect to collateralized debt obligations (CDOs), which often carry a leveraged portfolio of subprime RMBS among their underlying assets.

As shown in the table at bottom, as of January 28, 2008 deterioration in credit quality for 2006 and 2007 vintage subprime loans is concentrated in tranches originally rated A or below (i.e., in mezzanine or subordinate tranches). And downgrades are progressively more prevalent in lower rating tiers, as would be expected. Because Moody's did not anticipate the magnitude of delinquencies and losses on the underlying loans, however, the number of rating downgrades for 2006 and 2007 vintage subprime RMBS increased dramatically from historical averages. Moreover, in some cases securities were downgraded multiple rating levels. Moody's has correspondingly updated its methodology for rating subprime RMBS to account for this unexpectedly poor loan performance, as shown in the box at right.

The Origins of Structured Finance: Mortgage Loans and GSEs

Early structured finance innovations stemmed from efforts to boost liquidity in the US mortgage markets. To encourage small banks to write more mortgage loans, without taking on excess risk, it was necessary to help reduce those risks. This was accomplished by "pooling" the mortgages of many home buyers into a single mortgage-backed security, or MBS, which redistributed the risk of non-payment to investors and allowed banks to lend money to a greater number of borrowers.

The first organizations to buy mortgages from lending banks and "package" them into MBS were government-sponsored entities (GSEs) such as the Government National Mortgage Association ("GNMA" or "Ginnie Mae") and the Federal National Mortgage Association ("FNMA" or "Fannie Mae").

Later, many "private label" institutions also issued MBS, boosting volumes and securitizing a broader range of mortgage types that in some cases did not meet GSE standards. An array of other asset-backed securities (ABS) were also marketed, pooling cash flows from credit card receivables, auto loans, and commercial leases, among others.

*Recent Updates to Moody's Subprime RMBS Rating Methodology**

- Increased loss estimates for high-CLTV and high-LTV loans
- Increased risk assumptions for loans with low or no documentation
- Increased risk assumptions for unseasoned loans in securitizations
- Increased enhancement for securitizations when delinquency triggers do not account for modifications, repurchases and substitutions
- Increased frequency and severity assumptions for closed-end second lien loans.

** For the most recent updates on Moody's rating methodology, rating transitions, and other related topics, visit www.moodys.com/subprime.*

Subprime Rating Transitions as of 01/28/08

2006 Vintage First and Second Lien Transactions

	Current Rtg/Last Rating Before WR											
Orig Rtg	Aaa	Aa	A	Baa	Ba	B	Caa	Ca	C	Total UPG	Total DNG	Total Ratings
Aaa	96.2% (2,212)	2.8% (65)	0.3% (6)	0.2% (5)	0.3% (8)	0.1% (3)					87	2,299
Aa		89.9% (1,295)	1.0% (15)	2.8% (40)	2.6% (37)	1.6% (23)	0.9% (13)	0.8% (11)	0.5% (7)	0	146	1,441
A			38.3% (565)	25.2% (372)	17.0% (251)	10.4% (154)	2.6% (38)	2.0% (30)	4.4% (65)	0	910	1,475
Baa				14.8% (224)	16.3% (247)	28.3% (428)	12.5% (189)	10.7% (161)	17.3% (262)	0	1,287	1,511
Ba					5.1% (28)	15.1% (83)	6.7% (37)	11.8% (65)	61.2% (336)	0	521	549
										0	2,951	7,275

2007 Vintage First and Second Lien Transactions

	Current Rtg/Last Rating Before WR											
Orig Rtg	Aaa	Aa	A	Baa	Ba	B	Caa	Ca	C	Total UPG	Total DNG	Total Ratings
Aaa	100.0% (1,140)										0	1,140
Aa	0.1% (1)	99.4% (695)			0.4% (3)					1	3	699
A			55.3% (377)	24.2% (165)	12.0% (82)	5.7% (39)	1.6% (11)	0.9% (6)	0.3% (2)	0	305	682
Baa				29.7% (192)	18.1% (117)	22.6% (146)	8.7% (56)	5.7% (37)	15.3% (99)	0	455	647
Ba					23.1% (34)	10.9% (16)	13.6% (20)	10.2% (15)	42.2% (62)	0	113	147
										1	876	3,315

Measures to Increase Transparency and Help Restore Market Confidence

In its communication with the markets and with regulators, Moody's has identified several measures that would help increase transparency in the subprime RMBS market as well as help restore market confidence:

- *Richer data/better risk models with which to conduct RMBS analysis (performance data on 2006 vintage loans has already been incorporated into Moody's updated rating methodology, which partially addresses this need).*
- *Third-party loan review to improve the accuracy of information that Moody's and other market participants rely on in analyzing RMBS.*
- *Higher information standards for mortgage originations.*
- *Stronger representations and warranties from creditworthy entities as to the quality and accuracy of information presented to investors, rating agencies, and other market participants.*
- *Better information/knowledge about who holds which instruments/where exactly risk resides in the market.*

Additional Subprime and RMBS Resources

What to Read

Full coverage of subprime issues across all markets — including rating actions, special reports, and RMBS indices — is available at www.moodys.com/subprime

Subprime & the Credit Markets -- Structured Finance
Subprime, Liquidity and the Current Environment: Moody's Views Across the Entire Market

Structured Finance | Financial Institutions | Corporate Finance | Market Highlights | Events

Moody's latest releases tracking developments in the challenged subprime mortgage market are linked here for your reference. Please check back regularly as updates occur frequently.

Press Releases | Rating Action Lists | Special Reports | Briefings/Teleconferences | RMBS Indices (2007) | ABCP Market Data

Press Releases

Moody's publishes updates on RMBS rating actions

4 Feb 2008

Our press release announcing the publication of four new updates on RMBS: "Rating Changes in the U.S. Asset-Backed Securities Market: 2007 Fourth Quarter Update," "Rating Changes in the U.S. Residential Mortgage-Backed Securities Market: 2007 Second Half Update," "U.S. Alt-A RMBS 2005-2007 Vintage Rating Actions Update: January 2008,"and "U.S. Subprime RMBS 2005-2007 Vintage Rating Actions Update: January 2008."

Moody's hosts periodic conferences and teleconferences on significant market developments. Click the "events" tab on the dedicated subprime page for a list of upcoming events as well as transcripts & replays of past events.

Moody's Contacts

For answers to specific queries on subprime and other related topics, please contact:

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STANDARD
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S&P's steps to further manage potential conflicts of interest, strengthen the ratings process, and better serve the markets

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Governance: Ensuring Integrity of the Ratings Process

- Establish an *Office of the Ombudsman* that will address concerns related to potential conflicts of interest and analytical and governance processes that may be raised by issuers, investors, employees and other market participants across S&P's businesses. The Ombudsman will have oversight of the handling of all issues, with authority to escalate any unresolved matters, as necessary, to the CEO of The McGraw-Hill Companies and the Audit Committee of the Board of Directors.
- Engage an external firm to periodically conduct an independent review of S&P Ratings' compliance and governance processes and issue a public opinion that addresses whether S&P is effectively managing potential conflicts of interest and maintaining the independence of its ratings.
- Hold periodic reviews with the Audit Committee of the McGraw-Hill Board to discuss S&P Rating's overall governance and compliance functions. The reviews will include: (1) key business measures of ratings quality and compliance effectiveness, (2) the concerns and resolution of issues addressed by the Office of the Ombudsman, and (3) results of the independent reviews, by an external firm, of S&P Ratings' overall governance and compliance processes.
- Formalize functions with responsibility for policy governance, compliance, criteria management and quality assurance of the ratings and make them separate and independent from the ratings business units.
- Establish an enterprise-wide *Risk Assessment Oversight Committee* that operates separately and independently of the ratings business. The Committee will assess all risks that could impact the ratings process. This committee will also assess the feasibility of rating new types of securities.
- Implement "look back" reviews to ensure the integrity of prior ratings, whenever an analyst leaves to work for an issuer.
- Institute periodic rotations for lead analysts.
- Increase the level of existing employee training to ensure compliance with policies.

Analytics: Enhancing Quality of Ratings Analysis and Opinions

- Improve the surveillance process through: (a) additional resources and ongoing separation of new rating and rating surveillance functions in Structured Finance (b) strengthen surveillance in Corporates & Governments through the expanded use of search and market based tools and through oversight of surveillance separate from the business, and (c) regular adding of surveillance tools to make the surveillance process more timely and effective
- Establish a *Model Oversight Committee* within the Quantitative Analytics Group, which will be separate from and independent of the business unit, to assess and validate the quality of data and models used in our analytical processes.

- Increase annual analyst training requirements, enhance training programs and establish an analyst certification program.
- Complement traditional credit ratings analysis by highlighting non-default risk factors such as liquidity, volatility, correlation and recovery, that can influence the valuation and performance of rated securities and portfolios of these securities.

Information: Providing Greater Transparency and Insight to Market Participants

- Simplify and provide broader market access to ratings criteria, underlying models and analytical tools.
- Include "what if" scenario analysis in rating reports to explain key rating assumptions and the potential impact of positive or negative events on the rating.
- Improve the quality and integrity of information by working with market participants to improve disclosure of information on collateral underlying structured securities. In addition, implement procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities.
- More broadly disseminate long- and short-term rating performance data.
- Better explain the comparability of ratings across asset classes/issuer types (structured vs. corporate vs. government).
- Make available a Landmark Deal Report which summarizes new structures and major issues, and distribute the report widely to investors, intermediaries, issuers, regulators and media.
- Enhance access to S&P's code of ethics and disclosures through a link to the Global Regulatory Affairs section of www.standardandpoors.com.
- Establish greater minimum portfolio disclosure criteria for structured securities servicers (e.g. ABCP and SIVS).
- Develop an early warning indicator to investors that a key credit quality attribute (e.g. delinquencies; losses) of an issue or issuer differs from our expectations and has or may trigger a full review by S&P surveillance.
- Develop an identifier to the ratings of securitizations that will highlight to the market that: (a) the rating is on a securitization, and (b) the rating is on a new type of rating structure or securitization.

Education: More Effectively Educating the Marketplace about Credit Ratings and Rated Securities

- Publish a *Credit Ratings User Manual and Investor Guidelines* to promote better understanding of the ratings process and the role of ratings in the financial markets.
- Broaden distribution of analysis and opinions via web and other media.
- Launch market outreach program to promote better understanding of complex securities S&P rates.
- Establish an Advisory Council with membership that includes risk managers, academics and former government officials to provide guidance on addressing complex issues and establish topics for market education.
- Work with other NRSROs to promote ratings quality through the introduction of industry best practices and issuer disclosure standards.

S&P's current policies and practices

Governance: Independence and Quality of Ratings

- Ratings decisions are always made by committees.
- Personnel who are involved in commercial activities may not vote on a rating committee.
- Analysts' compensation is not linked to number of ratings an analyst is involved in, nor is it linked to the revenues or profits attributable to an analyst's ratings work.
- Existing policies prohibit analysts from providing consulting or advisory services or participating in structuring transactions.
- Separate group determines appropriateness of rating new structures; periodically declines to rate securities that do not meet S&P Ratings' criteria.
- Existing policies restrict analysts' ownership of, and trading in, securities they rate and restrict information sharing by rating analysts.
- A Policy Governance Group exists that develops policies and ratings guidelines designed to preserve and enhance the integrity of S&P's ratings process.
- Analyst performance measurements are used to align compensation with quality and compliance
- A strong compliance function has been instituted in the S&P Ratings organization.

Analytics and Surveillance

- Ratings focus exclusively on creditworthiness/probability of default.
- Responsibility for surveillance of residential mortgage-backed securities (RMBS) and collateralized debt obligation (CDO) ratings lies with a separate group from the initial ratings.

Information: Transparency and Consistency

- Ratings track record updated and made publicly available, published annually with 30+ years of historic performance for Structured, Corporate and Government ratings.
- Structured finance models and underlying data are made available to investors and issuers.

Education and Outreach

- Rating criteria available on www.standardandpoors.com
- Public input and comment solicited for all new criteria and models.
- Research and rating actions released through the media.