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Rating Action on Subprime Asset Backed Securities

The rating agencies weighed in on the struggling home equity (HEL) mortgage market yesterday with an unprecedented number of negative watchlistings and downgrades. Standard and Poor's Ratings Services (S&P) placed 612 classes backed by first-lien, floating-rate HELs on watch for downgrade yesterday morning with the intent of downgrading the securities in the next few days. Not to be outdone, Moody's reacted late in the day, downgrading 399 securities backed by similar loans and placed 32 additional securities on watch for downgrade. **We have no exposure to the deals that were affected.**

All the affected deals were issued between the fourth quarter 2005 and the fourth quarter 2006. S&P targeted roughly \$12.1 billion in securities of which over 80% are rated 'BBB' or lower, with virtually none rated higher than 'single-A'. The securities constituted 25% of the 'BBB' rated securities and 46% of 'BB' rated securities issued during that time period. Moody's downgraded roughly \$5.2 billion in securities also predominately 'BBB' rated. Both agencies cited weak collateral performance, higher than expected loss trends and decreased credit support for today's actions. In the near future, we expect another batch of downgrades for Collateralized Debt Obligations (CDOs) with exposure to these securities in their collateral pool.

The housing market continues to struggle and it is not expected that it will improve anytime soon, especially for the subprime sector. In general, losses have been trending much higher than expected, and according to S&P's report, delinquencies and losses are running much higher than loans originated in 2000 which was considered to be the worst performing year. The main culprit is the affordability mortgage products. These adjustable-rate mortgages are characterized by having low to no down payments, no income verification and low initial interest rates which will reset substantially higher within the next year or two. The continued weakness in the housing sector, coupled with tighter credit standards and higher interest rates, will make a subprime borrowers' ability to meet those increased payments and/or refinance very difficult. As a result, delinquencies will continue to increase and expected losses will continue to be exacerbated as these borrowers face the upcoming resets.

We expect to have continued headlines within the subprime market, especially once the reset periods come into play. These headlines will be focused on the affordability mortgage loans backing floating-rate HELs and not the fixed-rate HELs in which we



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invest. Floating-rate HELs on average have double to triple the delinquencies of fixed-rate HELs. When considering the credit protection embedded in our HEL investments, we are more than adequately protected against principal losses as well as credit downgrades from any increases in defaults of the underlying collateral. We continue to actively monitor your holdings and will keep you apprised of any changes.

If you should have any questions, please feel free to contact either Scott Edwards, Director of Structured Products or Joyce Tay at 312-263-2900 or your AAM relationship contact.

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