

THE THEORY OF HOW THE FINANCIAL SYSTEM CREATED AAA-RATED ASSETS OUT OF SUBPRIME MORTGAGES

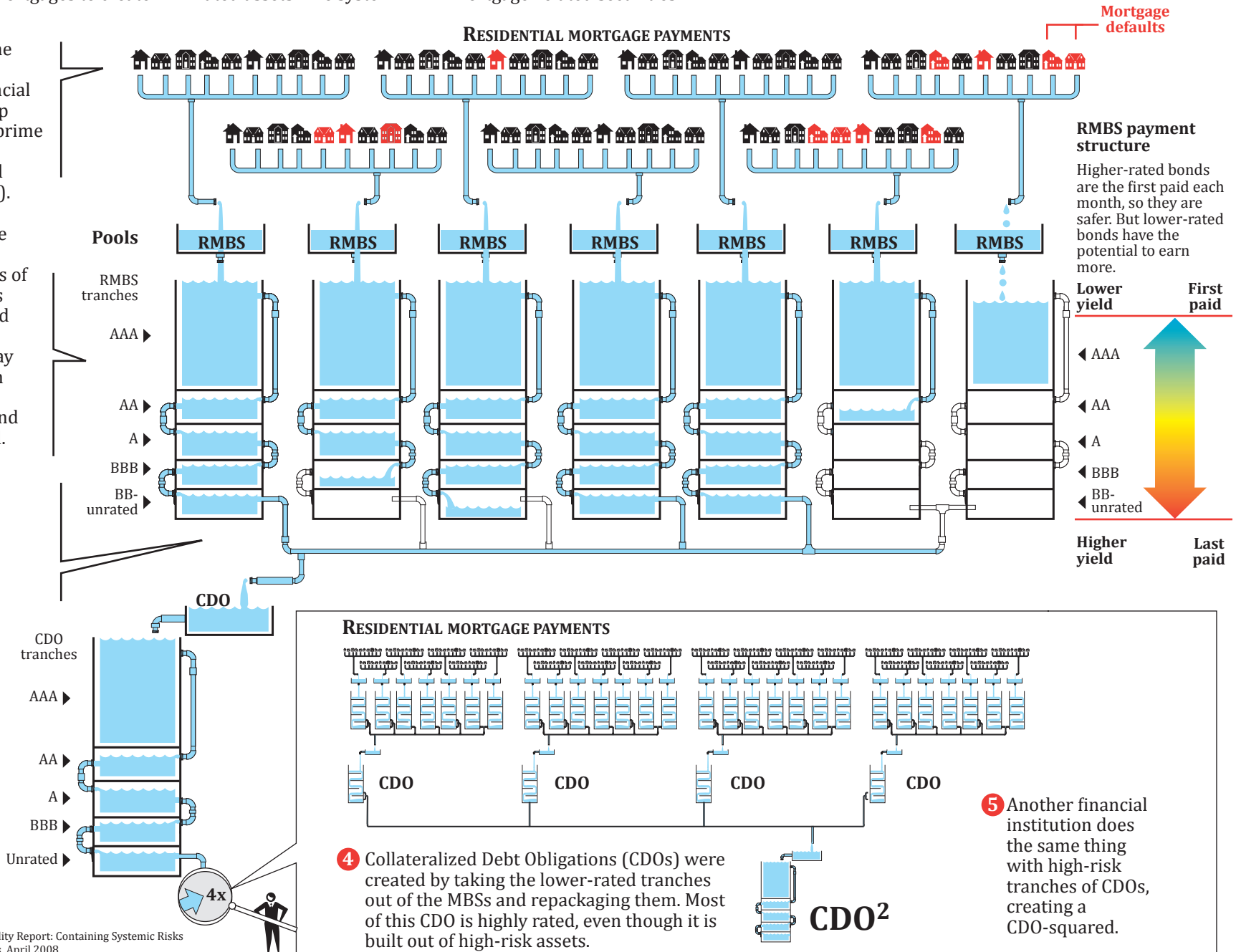
In the financial system, AAA-rated assets are the most valuable because they are the safest for investors and the easiest to sell. Financial institutions packaged and re-packaged securities built on high-risk subprime mortgages to create AAA-rated assets. The system

worked as long as mortgages all over the country and of all different characteristics didn't default all at once. When homeowners all over the country defaulted, there was not enough money to pay off all the mortgage-related securities.

1 People all over the country take out mortgages. Financial institutions group hundreds of subprime mortgages into Mortgage Backed Securities (MBSs).

2 The securities are grouped into tranches by levels of risk and earnings potential for bond holders. When everybody can pay their mortgage in full each month, each group of bond holders gets paid.

3 The mortgage payments are collected by a financial institution and payments distributed to bond holders. Higher rated tranches are paid first. When monthly mortgage payments are not made, payments may not reach holders of lower-rated tranches.



4 Collateralized Debt Obligations (CDOs) were created by taking the lower-rated tranches out of the MBSs and repackaging them. Most of this CDO is highly rated, even though it is built out of high-risk assets.

5 Another financial institution does the same thing with high-risk tranches of CDOs, creating a CDO-squared.