This Settlement Agreement ("Agreement") is entered into between the United States, acting through the United States Department of Justice ("Department of Justice"), and Morgan Stanley. The United States and Morgan Stanley are collectively referred to as "the Parties."

RECITALS

A. The Department of Justice conducted investigations of the packaging, marketing, sale, structuring, arrangement, and issuance of certain residential mortgage-backed securities ("RMBS") by Morgan Stanley between 2005 and 2007. Based on those investigations, the United States believes that there is an evidentiary basis to compromise potential legal claims by the United States against Morgan Stanley for violations of federal laws in connection with the packaging, marketing, sale, structuring, arrangement, and issuance of these RMBS.

B. Morgan Stanley acknowledges the facts set out in the Statement of Facts set forth in Annex 1, attached and hereby incorporated.

C. The State of New York is entering into an agreement with Morgan Stanley to resolve similar claims the State has against Morgan Stanley for violation of state laws in connection with these RMBS.

D. In consideration of the mutual promises and obligations of this Agreement, the Parties agree and covenant as follows:

TERMS AND CONDITIONS

1. **Payment.** Morgan Stanley shall pay a total amount of two billion, six-hundred million dollars ($2,600,000,000) to resolve pending and potential legal claims as set forth herein in connection with the creation, pooling, structuring, arranging, formation, packaging, marketing, underwriting, sale, or issuance of RMBS by Morgan Stanley ("Settlement Amount").

A. Within fifteen (15) business days of receiving written payment processing instructions from the Department of Justice, Morgan Stanley shall pay the Settlement Amount by electronic funds transfer to the Department of Justice.

B. The entirety of the Settlement Amount is a civil monetary penalty recovered pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), 12 U.S.C. §1833a.

2. **Covered Conduct.** "Covered Conduct" as used herein is defined as, prior to January 1, 2009, the creation, pooling, structuring, arranging, formation, packaging, marketing, underwriting, sale, or issuance of the RMBS identified in Annex 2 by Morgan Stanley and its current or former subsidiaries and affiliates, including but not limited to Morgan Stanley & Co., Inc., Morgan Stanley Credit Corporation, Morgan Stanley Mortgage Capital Holding LLC, Morgan Stanley ABS Capital I, Inc., Morgan Stanley Capital I, Inc., Saxon Asset Securities Company and Saxon Mortgage Services, Inc. The Covered Conduct includes representations, disclosures, or non-disclosures to RMBS investors made about or in connection with the activities set forth above, where the representation or non-disclosure involves information about or obtained during the process of originating, acquiring, securitizing, underwriting, or servicing residential mortgage loans included in the RMBS identified in Annex 2. The Covered Conduct does not include: (i) conduct relating to the origination of residential mortgages, except representations or non-disclosures to investors in the RMBS listed in Annex 2 about origination of, or about information obtained in the course of originating, such loans; (ii) representations or non-disclosures made in connection with collateralized debt obligations, other derivative securities, or the secondary trading by Morgan Stanley of RMBS, except to the extent that the representations or non-disclosures are related to the offering materials for the underlying RMBS

listed in Annex 2; and (iii) the servicing of residential mortgage loans, except representations or non-disclosures to investors in the RMBS listed in Annex 2 about servicing, or information obtained in the course of servicing, such loans.

3. **Cooperation.** Until the date upon which all investigations and any prosecution arising out of the Covered Conduct are concluded by the Department of Justice, whether or not they are concluded within the term of this Agreement, Morgan Stanley shall, subject to applicable laws or regulations: (a) cooperate fully with the Department of Justice (including the Federal Bureau of Investigation) and any other law enforcement agency designated by the Department of Justice regarding matters arising out of the Covered Conduct; (b) assist the Department of Justice in any investigation or prosecution arising out of the Covered Conduct by providing logistical and technical support for any meeting, interview, deposition or other sworn testimony, grand jury proceeding, or any trial or other court proceeding; (c) use its best efforts to secure the attendance and truthful statements or testimony of any officer, director, agent, or employee of any of the entities released in Paragraph 4 at any meeting or interview, deposition or other sworn testimony, or before the grand jury or at any trial or other court proceeding regarding matters arising out of the Covered Conduct; and (d) provide the Department of Justice, upon request, all non-privileged information, documents, records, or other tangible evidence regarding matters arising out of the Covered Conduct about which the Department of Justice or any designated law enforcement agency inquires.

4. **Releases by the United States.** Subject to the exceptions in Paragraph 5 ("Excluded Claims") and conditioned upon Morgan Stanley's full payment of the Settlement Amount and Morgan Stanley's full compliance with the terms in Paragraph 3 ("Cooperation"), the United States fully and finally releases Morgan Stanley, each of its current and former subsidiaries and

affiliated entities, and each of their respective successors and assigns (collectively, the "Released Entities"), from any civil claim the United States has against the Released Entities for the Covered Conduct arising under FIRREA, 12 U.S.C. § 1833a; the False Claims Act, 31 U.S.C. §§ 3729, *et seq.*; the Program Fraud Civil Remedies Act, 31 U.S.C. §§ 3801, *et seq.*; the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961, *et seq.*; the Injunctions Against Fraud Act, 18 U.S.C. § 1345; common law theories of negligence, payment by mistake, unjust enrichment, money had and received, breach of fiduciary duty, breach of contract, misrepresentation, deceit, fraud, and aiding and abetting any of the foregoing; or that the Civil Division of the Department of Justice has actual and present authority to assert and compromise pursuant to 28 C.F.R. § 0.45(d).

5. **Excluded Claims.** Notwithstanding the releases in Paragraph 4 of this Agreement, or any other term(s) of this Agreement, the following claims are specifically reserved and not released by this Agreement:

a. Any criminal liability;

b. Any liability of any individual;

c. Any liability arising under Title 26 of the United States Code (the Internal Revenue Code);

d. Any liability to or claims of the National Credit Union Administration, any Federal Home Loan Bank, or the Federal Deposit Insurance Corporation (including in its capacity as a corporation, receiver, or conservator) (the "FDIC");

e. Any liability to or claims of the United States of America, the Department of Housing and Urban Development/Federal Housing Administration, the Department of Veterans Affairs, or Fannie Mae or Freddie Mac relating to whole loans insured, guaranteed, or purchased by the Department of Housing and Urban Development/Federal Housing Administration, the Department of Veterans Affairs, or Fannie Mae or Freddie Mac, except claims based on or arising from the securitizations of any such loans in the RMBS listed in Annex 2;

f. Any administrative liability, including the suspension and debarment rights of any federal agency;

g. Any liability based upon obligations created by this Settlement Agreement;

h. Any liability for the claims or conduct alleged in the following qui tam actions, and no setoff related to amounts paid under this Agreement shall be applied to any recovery in connection with any of these actions:

(i) *United States, et al. ex rel. Szymoniak v. American Home Mortgage Servicing, Inc., Saxon Mortgage, Inc., et al.*, No. 0:10-cv-01465-JFA (D.S.C.);

(ii) *Sealed v. Sealed*, No. XX CIV XXXX (S.D.N.Y.)

(iii) *Sealed v. Sealed*, No. XX CIV XXXX (S.D.N.Y.)

(iv) *Sealed v. Sealed*, No. XX CIV XXXX (S.D.N.Y.)

6. **Releases by Morgan Stanley.** Morgan Stanley and any current or former affiliated entity and any of their respective successors and assigns fully and finally release the United States and its officers, agents, employees, and servants, from any claims (including attorney's fees, costs, and expenses of every kind and however denominated) that Morgan Stanley has asserted, could have asserted, or may assert in the future against the United States and its officers, agents, employees, and servants, related to the Covered Conduct to the extent released hereunder and the investigation and civil prosecution to date thereof.

7. **Waiver of Potential FDIC Indemnification Claims by Morgan Stanley.** Morgan Stanley hereby irrevocably waives any right that it otherwise might have to seek (and in any event agrees that it shall not seek) any form of indemnification, reimbursement or contribution from the FDIC in any capacity, including the FDIC in its Corporate Capacity or the FDIC in its Receiver Capacity for any payment under this Agreement.

8. **Waiver of Potential Defenses by Morgan Stanley.** Morgan Stanley and any current or former affiliated entity (to the extent that Morgan Stanley retains liability for the Covered Conduct associated with such affiliated entity) and any of their respective successors and assigns waive and shall not assert any defenses Morgan Stanley may have to any criminal prosecution or administrative action relating to the Covered Conduct that may be based in whole or in part on a contention that, under the Double Jeopardy Clause in the Fifth Amendment of the Constitution, or under the Excessive Fines Clause in the Eighth Amendment of the Constitution, this Agreement bars a remedy sought in such criminal prosecution or administrative action.

9. **Unallowable Costs Defined.** All costs (as defined in the Federal Acquisition Regulation, 48 C.F.R. § 31.205-47) incurred by or on behalf of Morgan Stanley, and its present or former officers, directors, employees, shareholders, and agents in connection with:

a. The matters covered by this Agreement;

b. The United States' audit(s) and civil investigation(s) of the matters covered by this Agreement;

c. Morgan Stanley's investigation, defense, and corrective actions undertaken in response to the United States' audit(s) and civil and any criminal investigation(s) in connection with the matters covered by this Agreement (including attorney's fees);

d. The negotiation and performance of this Agreement; and

e. The payment Morgan Stanley makes to the United States pursuant to this Agreement, are unallowable costs for government contracting purposes (hereinafter referred to as "Unallowable Costs").

10. **Future Treatment of Unallowable Costs.** Unallowable Costs will be separately determined and accounted for by Morgan Stanley, and Morgan Stanley shall not charge such Unallowable Costs directly or indirectly to any contract with the United States.

11. This Agreement is governed by the laws of the United States. The Parties agree that the exclusive jurisdiction and venue for any dispute relating to this Agreement is the United States District Court for the Northern District of California.

12. This Agreement is intended for the benefit of the Parties only and does not create any third-party rights.

13. The Parties acknowledge that this Agreement is made without any trial or adjudication or judicial finding of any issue of fact or law, and is not a final order of any court or governmental authority.

14. Each Party shall bear its own legal and other costs incurred in connection with this matter, including the preparation and performance of this Agreement.

15. Each Party and signatory to this Agreement represents that it freely and voluntarily enters into this Agreement without any degree of duress or compulsion.

16. Nothing in this Agreement constitutes an agreement by the United States concerning the characterization of the Settlement Amount for the purposes of the Internal Revenue laws, Title 26 of the United States Code.

17. For the purposes of construing this Agreement, this Agreement shall be deemed to have been drafted by all Parties and shall not, therefore, be construed against any Party for that reason in any dispute.

18. This Agreement constitutes the complete agreement between the Parties. This Agreement may not be amended except by written consent of the Parties.

19. The undersigned counsel represent and warrant that they are fully authorized to execute this Agreement on behalf of the persons and entities indicated below.

20. This Agreement may be executed in counterparts, each of which constitutes an original and all of which constitute one and the same Agreement.

21. This Agreement is binding on Morgan Stanley's successors, transferees, heirs, and assigns.

22. All Parties consent to the disclosure to the public of this Agreement, and information about this Agreement, by Morgan Stanley and/or the United States.

23. This Agreement is effective on the date of signature of the last signatory to the Agreement. Facsimiles of signatures shall constitute acceptable, binding signatures for purposes of this Agreement.

For the United States:

Dated: 2/11/16

STUART F. DELERY
Acting Associate Attorney General
United States Department of Justice

For Morgan Stanley:

Dated: 2/10/16

ERIC F. GROSSMAN
Executive Vice President & Chief Legal Officer
Morgan Stanley

ANNEX 1

STATEMENT OF FACTS

Between 2006 and 2007, Morgan Stanley securitized thousands of subprime residential mortgage loans and sold the resulting residential mortgage-backed securities ("RMBS") to investors, including federally-insured financial institutions. Investors, including federally-insured financial institutions, suffered billions of dollars in losses from investing in RMBS issued by Morgan Stanley between 2006 and 2007.

Generally, if borrowers of the mortgage loans in an RMBS make their expected loan payments, RMBS investors will receive expected principal and interest payments on their investment. Conversely, if a sufficient number of borrowers default, principal and interest payments to RMBS investors may not be made. A number of factors, including the characteristics of the borrowers and the value of the properties underlying an RMBS, play a role in determining the capital structure of the RMBS and its expected performance and price.

Morgan Stanley's offering documents represented to investors, including federally-insured financial institutions or their subsidiaries and affiliates, various information about the RMBS, including the characteristics of the underlying subprime mortgage loans.[1] Morgan Stanley also prepared presentation materials (defined below) that it used in discussions with potential investors that described the due diligence process for reviewing pools of loans prior to securitization. Morgan Stanley did not disclose to securitization investors that employees of Morgan Stanley received information that, in certain instances, loans that did not comply with underwriting guidelines and lacked adequate compensating factors and/or had understated loan-

[1] The registration statement, prospectus, the prospectus supplement, and any free-writing prospectuses, including the mortgage loan schedule, all of which are filed with the U.S. Securities and Exchange Commission (SEC), are referred to collectively as "offering documents."

to-value ratios were included in the RMBS sold and marketed to investors. Likewise, as described below, certain of Morgan Stanley's actual due diligence practices did not conform to the description of the process set forth in certain of the presentation materials prepared for and used with potential investors.

Morgan Stanley's RMBS Subprime Securitization Process

Between 2006 and 2007, Morgan Stanley purchased subprime residential mortgage loans, securitized most of those loans into RMBS, and sold the RMBS to investors. For many of these RMBS, Morgan Stanley served as the sponsor, depositor, and underwriter of the RMBS. Morgan Stanley purchased "pools" of subprime mortgage loans from third-party originators, including New Century Mortgage Corporation (New Century). Morgan Stanley then securitized these loans under such shelves as the Morgan Stanley ABS Capital I Inc. or "MSAC" shelf.

The process leading up to the securitization of subprime mortgage loans typically began with Morgan Stanley's bidding for a pool of loans, basing its bid on information from the originator regarding the characteristics of the loans. After a successful bid, Morgan Stanley received information about the specific subprime mortgage loans in the pool, which was provided by the originator in the form of a loan "data tape." If this information showed material discrepancies between the loans that Morgan Stanley expected to receive and the loans in the pool that it actually received, Morgan Stanley could take a number of actions, including demanding that the originator substitute different loans, adjusting the price of the pool, or refusing to purchase loans with characteristics different from the information the originator had provided about the characteristics of loans in the pool. Thereafter, Morgan Stanley engaged in due diligence of the loans, committing significant resources to that endeavor. Based on its due diligence, Morgan Stanley could refuse to purchase loans for many reasons, including that the loans did not conform to applicable underwriting guidelines and lacked sufficient compensating factors, did not comply with applicable laws, were missing required documentation, relied on appraisals that were not sufficiently supported, or were secured by properties presenting unacceptable health and safety risks.

According to drafts of the Securitized Products Group's business plan in December 2005, Morgan Stanley's goal was to become "the dominant global residential mortgage franchise on Wall Street in [its] target markets (Alt-A, Alt-B, subprime)."

Morgan Stanley developed and maintained business relationships with several large subprime loan originators, whom Morgan Stanley referred to as its clients. Morgan Stanley was aware that its "pull-through rate," or the percentage of loans in each prospective pool that it agreed to buy, was important to some of these originators, including New Century. Morgan Stanley also was aware that originators did not have to sell loans to Morgan Stanley. For example, in a 2006 performance evaluation, a member of Morgan Stanley's contract finance team wrote that the manager of credit-and-compliance due diligence should "stop fighting and begin recognizing the point that we need monthly volume from our biggest trading partners and that . . . the client does not have to sell to Morgan Stanley."

<u>Morgan Stanley's Representations to Investors</u>

In connection with each issuance of RMBS in 2006 and 2007, Morgan Stanley filed a final prospectus supplement for the RMBS and, at times, certain other documents, with the U.S. Securities and Exchange Commission (SEC). These additional documents included free writing prospectuses and schedules of the mortgage loans to be included in the RMBS. These documents supplemented offering documents that previously had been filed with the SEC, namely a registration statement and prospectus for the shelf off of which the RMBS were being issued. Morgan Stanley provided or made these offering documents available to potential investors. Morgan Stanley also prepared PowerPoint presentations and other materials that described its RMBS and its RMBS program and were used with potential investors through conversations, sales calls, presentations, and at industry conferences (collectively, "presentation materials").

Regarding the characteristics of the loans underlying the RMBS, Morgan Stanley's offering documents represented that "[n]one of the mortgage loans have loan-to-value ratios at origination,[2] or with respect to second-lien mortgage loans, combined loan-to-value ratios at origination,[3] in excess of 100%." Mortgage loans for which the unpaid principal balance exceeds the value of the underlying property are referred to colloquially as "underwater loans." The offering documents also contained other representations concerning LTV and CLTV ratios, including the number of loans in the security for each range of CLTV ratios (*e.g.*, the number of loans with CLTVs between 95 and 100 percent).

Morgan Stanley's prospectus supplements represented that "[t]he scope of [Morgan Stanley's] mortgage loan due diligence varies based on the credit quality of the mortgage loans." Morgan Stanley's prospectus supplements also represented that "[t]he mortgage loans originated

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[2] The prospectus supplement defined the loan-to-value ratio, or LTV, as "ratio of the principal balance of such mortgage loan at the date of determination to (a) in the case of a purchase, the lesser of the sale price of the mortgaged property and its appraised value at the time of sale or (b) in the case of a refinancing or modification, the appraised value of the mortgaged property at the time of the refinancing or modification."

[3] The prospectus supplement defined the combined loan-to-value ratio, or CLTV, as "the ratio of the principal balance of the second-lien mortgage loan, together with the outstanding balance of the related first-lien mortgage loan, at the date of determination to (a) in the case of a purchase, the lesser of the sale price of the mortgaged property and its appraised value at the time of sale or (b) in the case of a refinancing or modification, the appraised value of the mortgaged property at the time of the refinancing or modification."

or acquired by [the originator] were done so in accordance with the underwriting guidelines established by [the originator]." These documents further represented that "[o]n a case-by-case basis, exceptions to the [originator's guidelines] are made where compensating factors exist." Furthermore, the offering documents represented that "[i]t is expected that a substantial portion of the mortgage loans will represent these exceptions." Compensating factors are borrower characteristics or loan attributes that provide assurances sufficient to counteract the risks manifested by a borrower's failure to otherwise meet the originator's underwriting guidelines. Finally, in the base prospectus for the MSAC shelf, in a section titled "Representations by Sellers or Originators; Repurchases," Morgan Stanley stated that "the depositor [Morgan Stanley] will not include any loan in the trust fund for any series of securities if anything has come to the depositor's attention that would cause it to believe that the representations and warranties of a seller or originator will not be accurate and complete in all material respects in respect of the loan as of the date of initial issuance of the related series of securities."

Morgan Stanley also described in presentation materials used with potential investors certain aspects of its MSAC securitization program, including the due diligence process it employed when acquiring residential mortgage loans to identify and exclude certain loans. In these materials, Morgan Stanley described two types of loan-level due diligence it performed. The first type, valuation due diligence, assessed whether information concerning the value of the collateral underlying the mortgage loans sufficiently supported the appraised value of the properties at loan origination. For example, in certain presentation materials used with potential investors, Morgan Stanley stated the purpose of its valuation due diligence: "Morgan Stanley has taken a fundamental view that managing loss severity is the best way to manage portfolio performance. Accordingly, Morgan Stanley has designed a comprehensive valuation review process to target loans with valuation risk." Additionally, Morgan Stanley stated in presentation materials used with potential investors, that, as part of its valuation due diligence process, Morgan Stanley would reject loans with an unacceptable negative variance between the appraised value of the mortgaged property, as provided by the originator, and an alternative value Morgan Stanley ordered, called a broker's price opinion ("BPO"). For example, in presentations used with potential investors titled "MSAC Home Equity Program Overview," Morgan Stanley stated that, "[u]ltimately, Morgan Stanley excludes loans with unacceptable properties or any loan with a BPO value exhibiting an unacceptable negative variance from the original appraisal." The appraisals that were reviewed by this process were the same appraisals that were subsequently used to calculate the LTV and CLTV ratios included in offering documents for Morgan Stanley's RMBS.

The second type of loan-level due diligence, credit-and-compliance due diligence, was conducted on a sample of mortgage loans in bulk pools that Morgan Stanley purchased, assessing the credit risks of the sampled loans and testing for their conformance with applicable laws, affordability, and evidence of the loan's benefits to the borrower, among other things. Certain presentation materials used with potential investors during the period from late 2005 to April 2006 stated that "Loans selected for review include 100% of loans with: Low FICO scores, Low credit grades, Poor prior mortgage payment histories, High debt to income ratios, High LTV, Borrowers with multiple loans." These presentations used with potential investors also stated that Morgan Stanley would exclude certain types of loans on a programmatic basis, such as "seasoned or delinquent loans" and "certain high LTV transactions including 100% LTV cash out refinance." During the period from June 2006 to January 2007, certain presentation materials used with potential investors stated that Morgan Stanley's credit-and-compliance due diligence sample on subprime bulk loans consisted of "roughly 2/3 adversely selected loans and 1/3 randomly selected loans."

In the MSAC overview presentation used with potential investors, Morgan Stanley regularly told potential investors that it "has focused on partnering with the large whole loan originators who have strong credit cultures and risk management." Morgan Stanley further represented in its prospectus supplements that "[p]rior to acquiring any residential mortgage loans," Morgan Stanley conducted "a review of the related mortgage loan seller that is based upon the credit quality of the selling institution," which "may include reviewing select financial information for credit and risk assessment and conducting an underwriting guideline review, senior level management discussion and/or background checks." Morgan Stanley stated "[t]he underwriting guideline review entails a review of the mortgage loan origination processes and systems. In addition, such review may involve a consideration of corporate policy and procedures relating to state and federal predatory lending, origination practices by jurisdiction, historical loan level loss experience, quality control practices, significant litigation and/or material investors."

Morgan Stanley's Valuation Due Diligence

As part of its valuation due diligence, Morgan Stanley obtained broker's price opinions ("BPOs") for a percentage of the loans in a pool. BPOs are an estimate of value on a property from an independent real estate broker. In its presentation materials used with potential investors, Morgan Stanley stated that, "[u]ltimately, Morgan Stanley excludes loans with unacceptable properties or any loan with a BPO value exhibiting an unacceptable negative variance from the original appraisal." Although Morgan Stanley never had a set numerical threshold for the disparity between a lower BPO value and an original appraisal value that would automatically result in a loan being rejected for purchase. Morgan Stanley never rejected a loan based solely on the BPO results.

Morgan Stanley had internal criteria for assessing BPO values. When a BPO value had a negative variance of 6 percent or less (*i.e.*, it was smaller than the appraisal value by 6 percent or less) and the BPO LTV or CLTV ratio was not over 100 percent, the loans were "acceptable for purchase for Value." For loans with BPO values that were 7 to 13 percent below the appraisal values, Morgan Stanley used the borrower's credit characteristics, such as FICO score, to evaluate whether to accept the loans. In presentation materials used with potential investors, Morgan Stanley identified risk factors used to target loans with valuation risk. None of these eleven risk factors related to a borrower's credit characteristics.

Morgan Stanley flagged the remaining loans, including every loan where the BPO value had a negative variance from the appraisal value of more than 13 percent, for reconsideration. Morgan Stanley reconsidered these loans using a process it referred to as "mitigation." Mitigation was a process of reviewing the original appraisal, BPO, and other information, in order to assign an additional estimate of value for the property and determine whether to purchase the loan notwithstanding the negative BPO variance or to send it to "tie-out" for review.[4] Mitigation was described by one Morgan Stanley valuation due diligence employee in a March 2006 email as "the process before tieout where we look at the appraisals and bpo's and try to pull as many files as we can into the deal before we get to tieout." One employee of a loan

[4] Tie-out was the final step in the valuation due diligence process in which Morgan Stanley and the originator discussed the loans as to which Morgan Stanley had been unable to determine that the appraisal values were sufficiently supported. At tie-out, the originator was given an opportunity to provide additional information, including information about the credit characteristics of the borrower, to support the appraisal values of the properties. Loans that went to tie-out were rejected for purchase if, after consideration of any additional information supplied by the originator, the appraisal values were not sufficiently supported in Morgan Stanley's view.

originator, in an email concerning an October 2006 loan pool, encouraged a Morgan Stanley employee to "[p]lease, Mitigate, mitigate, mitigate!!!" Neither Morgan Stanley's offering documents nor the presentation materials it used with potential investors mentioned this "mitigation" process.

Beginning in April 2006, Morgan Stanley expanded its "risk tolerance" for valuation due diligence. For example, in April 2006, the head of valuation due diligence at Morgan Stanley notified his supervisor: "Attached you will find the analysis for the final kick outs for New Century this month. I also included the figures to show what we pulled in that had CLTVs to 110% and 120%." An early May 2006 presentation for Morgan Stanley's subprime desk by the head of valuation due diligence explained "Risk Decisioning" used to increase the pull through rate. The risk decisioning methodology allowed the valuation due diligence personnel to accept for purchase loans with up to 105, 110, or 120 CLTVs, depending on the borrower's credit characteristics. The "Desk and Valuation [were] to agree on risk decisioning methodology."

On May 31, 2006, a member of the valuation due diligence team stated that, as to New Century's most recent pool, "a greater number of files were 'removed' during the mitigation process based on a slightly higher risk tolerance." In a reply email, the head of valuation due diligence stated "please do not mention the 'slightly higher risk tolerance' in these communications. We are running under the radar and do not want to document these types of things." In an email exchange in June 2006 regarding loans from the previous month's loan pool, one valuation team member wrote that"[o]ur team pulled in everything possible, so the loans that were kicked are the worst of the worst."

Starting in April 2006, at times Morgan Stanley conducted an additional, post-mitigation review of loans flagged for tie-out in order to approve the loans for purchase for value. This additional review occurred on a number of occasions. For example, in a November 21, 2006 email, a member of the valuation due diligence team sent a list of loans marked for tie-out to the head of valuation due diligence, adding, "I assume you will want to do your 'magic' on this one?" In another instance from July 2006, this additional review resulted in clearing dozens of loans for purchase after less than one minute of review per loan file. Through this additional review, Morgan Stanley accepted loans for purchase when it had information indicating that the mortgage loans had CLTV ratios in excess of 100 percent.

In Morgan Stanley's offering documents, the representations to investors were based on the appraisals or purchase prices provided by originators from whom Morgan Stanley purchased subprime mortgage loans. The offering documents did not reflect the additional information Morgan Stanley acquired for certain loans during its valuation due diligence showing a lower value for the collateral than shown in the appraisals. In 18 MSAC trusts with New Century loans,[5] Morgan Stanley securitized nearly 5,000 loans with BPO values that were at least 15 percent lower than the appraisal values at loan origination or the purchase prices. In these same trusts, Morgan Stanley securitized nearly 9,000 loans with BPO values resulting in CLTV ratios over 100 percent and approximately 1,000 loans where the property value estimates that Morgan Stanley calculated during the mitigation process resulted in CLTV ratios over 100 percent.

Morgan Stanley's Credit and Compliance Due Diligence

In certain respects, the manner in which Morgan Stanley selected the sample of loans for credit-and-compliance due diligence from a loan pool it considered purchasing varied depending

[5] MSAC 2006 HE3-HE8, MSAC 2006 NC-1-5, MSAC 2007 HE1-3, MSAC 2007 NC-1-4.

on the originator that sold the loans. For some originators, such as New Century, Morgan Stanley typically included a quarter of the loans in the pool in its credit-and-compliance diligence sample between 2005 and 2007.

Morgan Stanley's credit-and-compliance due diligence of loans for its MSAC shelf did not conform to certain representations it made in presentation materials used with potential investors. For example, its sampling did not consist of one-third randomly selected loans and two-thirds adversely selected loans. Between September 2006 and December 2006, Morgan Stanley randomly selected for credit-and-compliance due diligence 46 of the approximately 6,900 loans it reviewed from among the 26,000 loans it purchased from New Century. Morgan Stanley also did not include in its sample every loan with an LTV ratio over 90 even though certain versions of the presentation materials used with potential investors during the 2005 to mid-2006 period stated that it would sample all "high-LTV loans," which had been defined in its offering documents as any loan with an LTV ratio over 80.

Morgan Stanley also securitized certain loans that neither comported with the originators' underwriting guidelines nor had adequate compensating factors. In reviewing loans for credit-and-compliance due diligence purposes, Morgan Stanley retained the services of a third-party due diligence provider named the Clayton Group. In general, Clayton graded a loan "EV1" when the loan complied with the applicable underwriting guidelines and was originated in compliance with applicable laws. Clayton generally graded a loan as "EV2" when the loan did not comply with applicable underwriting guidelines in certain respects but had sufficient compensating factors to justify such exceptions; however, Morgan Stanley afforded Clayton limited discretion in waiving exceptions to underwriting guidelines based on compensating factors. Clayton generally graded a loan as "EV3" when, in Clayton's determination, the loan was not originated in compliance with applicable laws and regulations, the loan did not comply with applicable underwriting guidelines and lacked sufficient offsetting compensating factors, the loan file was missing a key piece of documentation, or the loan had certain characteristics that, pursuant to Morgan Stanley's instructions, required the vendor to elevate the loan to Morgan Stanley for review.

Morgan Stanley reviewed all loans Clayton graded as EV3 and made a final determination regarding the loan's grade. After reviewing all loans that Clayton graded as EV3 loans, Morgan Stanley assigned its own grade of EV2 to a majority of these loans, which were subsequently purchased and securitized. For example, Clayton assigned a grade of EV3 to an equity cash out loan, noting, among other exceptions, that the borrower, a checker at a florist shop, had an unreasonable stated income of $9,000 per month and an LTV ratio of 95 percent. Morgan Stanley assigned a grade of EV2 in part because the borrower had been at her job for 19 years and the loan was a refinance transaction that reduced the borrower's total monthly expenses by $26.

Starting in April 2006, Morgan Stanley's finance team, which was responsible for purchasing and securitizing loan pools but not underwriting or due diligence, instituted a procedure whereby the finance team considered certain loans that Morgan Stanley's credit-and-compliance due diligence process had already recommended should not be purchased. According to an internal Morgan Stanley draft document drafted by its collateral analysis group, this process, known as "risk categorization," was "required when the Banker Team [elsewhere called the finance team] needs to increase the Pull Through Rate." At the direction of Morgan Stanley's finance team, Morgan Stanley credit-and-compliance due diligence personnel undertook this risk categorization, in which they would put each loan they had recommended not be purchased from certain loan pools into categories depending on the reason for rejecting the subprime mortgage loan. Morgan Stanley's finance team then decided which of these loans had "acceptable risk" in light of the credit profile of the entire pool as measured by the credit rating agencies models. Morgan Stanley examined thousands of loans through risk categorization and ultimately purchased and securitized hundreds of loans through this process.

As stated in Morgan Stanley's presentation materials used with potential investors, Morgan Stanley's credit-and-compliance due diligence did not involve reviewing the loan files for many of the loans in the pools that it purchased (typically around 75 percent of the loans in pools that it bought from New Century in 2006-2007), many of which were subsequently included in its RMBS. This percentage of loans remained unsampled for credit-and-compliance purposes despite indications that the unsampled portions of the pools contained loans that did not conform to Morgan Stanley's representations to investors. Morgan Stanley often excluded from its purchases over 10 percent of the New Century loans that it randomly sampled in a given month, but did not perform a credit and compliance review of the loan files of the remaining loans from which the random sample was drawn. Similarly, Morgan Stanley often kicked out between 20 and 25 percent of the adversely sampled loans that had been selected for due diligence in New Century pools, allowing other loans with the same "adverse selection" characteristics to be purchased and securitized without a loan file review for credit and compliance. Morgan Stanley's agreements with originators like New Century provided Morgan Stanley with the right to increase its sample size if it decided that its initial review warranted further analysis, but Morgan Stanley rarely exercised that right regardless of the results of its sampling. Morgan Stanley did not increase its credit-and-compliance due diligence samples, in part, because it did not want to harm its relationship with its largest subprime originators.

The Quality of Subprime Originators From Which Morgan Stanley Purchased Loans

In the MSAC overview presentation used with potential investors, Morgan Stanley regularly told potential investors that it "has focused on partnering with the large whole loan originators who have strong credit cultures and risk management." Morgan Stanley was aware of problematic lending practices of the subprime originators from which it purchased mortgage loans. In March 2006, the head of Morgan Stanley's valuation due diligence team reported that, "due to the deteriorating appraisal quality they are finding with all of the sellers," his team was "not able to mitigate as many loans as they use[d] to be able to during this process." In a December 2006 memorandum titled, "New Century Appraisal Kick Out Drivers," the head of Morgan Stanley's valuation due diligence team identified valuation problems with New Century loans, such as the "use of dated sales in declining or soft markets," "use of sales from outside of the neighborhood to support higher value," "use of sales clearly superior in quality of construction and/or appeal" and the overriding of appraisal reviews by New Century management. After describing the loans rejected by Morgan Stanley from an October 2005 New Century loan pool, a Morgan Stanley credit-and-compliance field due diligence manager reported to the banker team that "there [was] not a lot of 'common sense' being used when approving these types of [New Century] loans." In describing loans graded EV3 from the sample of loans reviewed in the December 2006 New Century pool, a Morgan Stanley credit-and-compliance field due diligence manager stated that "[t]he main issue again with the loans is due to sloppy underwriting and stretching the guidelines and exception approvals at New Century's management level."

ANNEX 2

ANNEX 2*

ACCT 2005-1
ACCT 2005-2
ACCT 2005-3
ACCT 2006-1
American Home Mortgage Assets Trust 2007-3
Ameriquest Mortgage Securities Asset-Backed Pass-Through Certificates, Series 2005-R1
Ameriquest Mortgage Securities Asset-Backed Pass-Through Certificates, Series 2005-R2
Ameriquest Mortgage Securities Asset-Backed Pass-Through Certificates, Series 2005-R7
Ameriquest Mortgage Securities Asset-Backed Pass-Through Certificates, Series 2005-R9
Ameriquest Mortgage Securities Asset-Backed Pass-Through Certificates, Series 2006-R2
Ameriquest Mortgage Securities Asset-Backed PTC, Series 2003-1
Ameriquest Mortgage Securities Asset-Backed PTC, Series 2003-6
Ameriquest Mortgage Securities Asset-Backed PTC, Series 2003-AR2
Ameriquest Mortgage Securities Asset-Backed PTC, Series 2003-AR3
Ameriquest Mortgage Securities Inc., Series 2002-B
Ameriquest Mortgage Securities Trust Series 2006-R2
AMIT 2005-1
AMIT 2005-2
AMIT 2005-4
AMIT 2006-1
Argent Mortgage Loan Trust 2005-W1
Argent Securities Inc., Asset-Backed Pass-Through Certificates, Series 2005-W2
Argent Securities Inc., Asset-Backed Pass-Through Certificates, Series 2005-W3
BARN NIM Notes, Series 2007-1
CHL Mortgage Pass-Through Trust, Series 2005-15
CHL Mortgage Pass-Through Trust, Series 2005-5
CHL Mortgage Pass-Through Trust, Series 2006-13
CIT Mortgage Loan Trust 2007-1
CMALT 2007-A4 (CitiMortgage Alternative Loan Trust Series 2007-A4)
CMSI 2007-7 (Citicorp Mortgage Securities Trust, Series 2007-7)
Countrywide Alternative Loan Trust (CWALT) 2005-19CB
Countrywide Alternative Loan Trust (CWALT) 2005-21CB
Countrywide Alternative Loan Trust (CWALT) 2005-37T1
Countrywide Alternative Loan Trust (CWALT) 2005-47CB
Countrywide Alternative Loan Trust (CWALT) 2005-50CB
Countrywide Alternative Loan Trust (CWALT) 2005-74T1
Countrywide Alternative Loan Trust (CWALT) 2005-75CB
Countrywide Alternative Loan Trust (CWALT) 2005-79CB
Countrywide Alternative Loan Trust (CWALT) 2005-86CB
Countrywide Alternative Loan Trust (CWALT) 2006-20CB

* Should a securitization inadvertently not be listed notwithstanding that Morgan Stanley or one of its subsidiaries or affiliates served as the issuer, sponsor, depositor, underwriter, or originator, that securitization will be treated as if it was listed.

Countrywide Alternative Loan Trust (CWALT) 2006-24CB
Countrywide Alternative Loan Trust (CWALT) 2006-27CB
Countrywide Alternative Loan Trust (CWALT) 2006-28CB
Countrywide Alternative Loan Trust (CWALT) 2006-32CB
Countrywide Alternative Loan Trust (CWALT) 2006-35CB
Countrywide Alternative Loan Trust (CWALT) 2006-45T1
Countrywide Alternative Loan Trust (CWALT) 2007-17CB
Countrywide Alternative Loan Trust (CWALT) 2007-3T1
Countrywide Home Loans Asset-Backed Certificates (CWABS), Series 2005-11
Ellington Loan Acquisition Trust 2007-1
Ellington Loan Acquisition Trust 2007-2
FHAMS 2005-AA5 (First Horizon Alternative Mortgage Securities Trust 2005-AA5)
FHASI 2006-2 (First Horizon Mortgage Pass-Through Trust 2006-2)
FHASI 2006-3 (First Horizon Mortgage Pass-Through Trust 2006-3)
FHASI 2006-AR2 (First Horizon Mortgage Pass-Through Trust 2006-AR2)
First Horizon Alternative Mortgage Securities Trust 2006-FA8
First Horizon Alternative Mortgage Securities Trust 2007-FA3
GE-WMC Asset-Backed Pass-Through Certificates, Series 2005-1
GE-WMC Asset-Backed Pass-Through Certificates, Series 2005-2
GE-WMC Asset-Backed Pass-Through Certificates, Series 2006-1
GMACM Mortgage Loan Trust 2005-AR3
GMACM Mortgage Loan Trust 2005-AR4
HERD LLC 2005-1
HERD LLC 2006-1
Home Equity Mortgage Loan Asset-Backed Trust, Series INABS 2005-A
Home Equity Mortgage Loan Asset-Backed Trust, Series INABS 2005-B
Home Equity Mortgage Loan Asset-Backed Trust, Series INABS 2005-D
Home Equity Mortgage Loan Asset-Backed Trust, Series INABS 2006-E
HSBC Home Equity Loan Trust (USA) 2006-1
HSBC Home Equity Loan Trust (USA) 2006-3
HSBC Home Equity Loan Trust (USA) 2007-3
IndyMac INDA Mortgage Loan Trust 2007-AR2
IndyMac INDX Mortgage Loan Trust 2005-AR35
IndyMac INDX Mortgage Loan Trust 2005-AR9
IndyMac INDX Mortgage Loan Trust 2006-AR25
IXIS 2005-HE1 (IXIS Real Estate Capital Trust 2005-HE1)
IXIS 2005-HE2 (IXIS Real Estate Capital Trust 2005-HE2)
IXIS 2005-HE3 (IXIS Real Estate Capital Trust 2005-HE3)
IXIS 2005-HE4 (IXIS Real Estate Capital Trust 2005-HE4)
IXIS 2006-HE1 (IXIS Real Estate Capital Trust 2006-HE1)
IXIS 2006-HE2 (IXIS Real Estate Capital Trust 2006-HE2)
IXIS 2006-HE3 (IXIS Real Estate Capital Trust 2006-HE3)
IXIS 2007-HE1 (IXIS Real Estate Capital Trust 2007-HE1)
Luminent Mortgage Trust 2005-1
Morgan Stanley ABS Capital I Inc. Trust 2005-HE1
Morgan Stanley ABS Capital I Inc. Trust 2005-HE2

Morgan Stanley ABS Capital I Inc. Trust 2005-HE3
Morgan Stanley ABS Capital I Inc. Trust 2005-HE4
Morgan Stanley ABS Capital I Inc. Trust 2005-HE5
Morgan Stanley ABS Capital I Inc. Trust 2005-HE6
Morgan Stanley ABS Capital I Inc. Trust 2005-HE7
Morgan Stanley ABS Capital I Inc. Trust 2005-NC1
Morgan Stanley ABS Capital I Inc. Trust 2005-NC2
Morgan Stanley ABS Capital I Inc. Trust 2005-WMC1
Morgan Stanley ABS Capital I Inc. Trust 2005-WMC2
Morgan Stanley ABS Capital I Inc. Trust 2005-WMC3
Morgan Stanley ABS Capital I Inc. Trust 2005-WMC4
Morgan Stanley ABS Capital I Inc. Trust 2005-WMC5
Morgan Stanley ABS Capital I Inc. Trust 2005-WMC6
Morgan Stanley ABS Capital I Inc. Trust 2006-HE3
Morgan Stanley ABS Capital I Inc. Trust 2006-HE4
Morgan Stanley ABS Capital I Inc. Trust 2006-HE5
Morgan Stanley ABS Capital I Inc. Trust 2006-HE6
Morgan Stanley ABS Capital I Inc. Trust 2006-HE7
Morgan Stanley ABS Capital I Inc. Trust 2006-HE8
Morgan Stanley ABS Capital I Inc. Trust 2006-NC1
Morgan Stanley ABS Capital I Inc. Trust 2006-NC3
Morgan Stanley ABS Capital I Inc. Trust 2006-NC4
Morgan Stanley ABS Capital I Inc. Trust 2006-NC5
Morgan Stanley ABS Capital I Inc. Trust 2006-WMC1
Morgan Stanley ABS Capital I Inc. Trust 2006-WMC2
Morgan Stanley ABS Capital I Inc. Trust 2007-HE1
Morgan Stanley ABS Capital I Inc. Trust 2007-HE2
Morgan Stanley ABS Capital I Inc. Trust 2007-HE3
Morgan Stanley ABS Capital I Inc. Trust 2007-HE4
Morgan Stanley ABS Capital I Inc. Trust 2007-HE5
Morgan Stanley ABS Capital I Inc. Trust 2007-HE6
Morgan Stanley ABS Capital I Inc. Trust 2007-HE7
Morgan Stanley ABS Capital I Inc. Trust 2007-NC1
Morgan Stanley ABS Capital I Inc. Trust 2007-NC2
Morgan Stanley ABS Capital I Inc. Trust 2007-NC3
Morgan Stanley ABS Capital I Inc. Trust 2007-NC4
Morgan Stanley ABS Capital I Inc. Trust 2007-SEA1
Morgan Stanley Capital I Inc. Trust 2006-HE1
Morgan Stanley Capital I Inc. Trust 2006-HE2
Morgan Stanley Capital I Inc. Trust 2006-NC2
Morgan Stanley Home Equity Loan Trust 2005-1
Morgan Stanley Home Equity Loan Trust 2005-2
Morgan Stanley Home Equity Loan Trust 2005-3
Morgan Stanley Home Equity Loan Trust 2005-4
Morgan Stanley Home Equity Loan Trust 2006-1
Morgan Stanley Home Equity Loan Trust 2006-2

Morgan Stanley Home Equity Loan Trust 2006-3
Morgan Stanley Home Equity Loan Trust 2007-1
Morgan Stanley Home Equity Loan Trust 2007-2
Morgan Stanley IXIS Real Estate Capital Trust 2006-1
Morgan Stanley IXIS Real Estate Capital Trust 2006-2
Morgan Stanley Mortgage Loan Trust 2005-1
Morgan Stanley Mortgage Loan Trust 2005-10
Morgan Stanley Mortgage Loan Trust 2005-11AR
Morgan Stanley Mortgage Loan Trust 2005-2AR
Morgan Stanley Mortgage Loan Trust 2005-3AR
Morgan Stanley Mortgage Loan Trust 2005-4
Morgan Stanley Mortgage Loan Trust 2005-5AR
Morgan Stanley Mortgage Loan Trust 2005-6AR
Morgan Stanley Mortgage Loan Trust 2005-7
Morgan Stanley Mortgage Loan Trust 2005-8SL
Morgan Stanley Mortgage Loan Trust 2005-9AR
Morgan Stanley Mortgage Loan Trust 2006-10SL
Morgan Stanley Mortgage Loan Trust 2006-11
Morgan Stanley Mortgage Loan Trust 2006-12XS
Morgan Stanley Mortgage Loan Trust 2006-13ARX
Morgan Stanley Mortgage Loan Trust 2006-14SL
Morgan Stanley Mortgage Loan Trust 2006-15XS
Morgan Stanley Mortgage Loan Trust 2006-16AX
Morgan Stanley Mortgage Loan Trust 2006-17XS
Morgan Stanley Mortgage Loan Trust 2006-1AR
Morgan Stanley Mortgage Loan Trust 2006-2
Morgan Stanley Mortgage Loan Trust 2006-3AR
Morgan Stanley Mortgage Loan Trust 2006-4SL
Morgan Stanley Mortgage Loan Trust 2006-5AR
Morgan Stanley Mortgage Loan Trust 2006-6AR
Morgan Stanley Mortgage Loan Trust 2006-7
Morgan Stanley Mortgage Loan Trust 2006-8AR
Morgan Stanley Mortgage Loan Trust 2006-9AR
Morgan Stanley Mortgage Loan Trust 2007-10XS
Morgan Stanley Mortgage Loan Trust 2007-11AR
Morgan Stanley Mortgage Loan Trust 2007-14AR
Morgan Stanley Mortgage Loan Trust 2007-12
Morgan Stanley Mortgage Loan Trust 2007-13
Morgan Stanley Mortgage Loan Trust 2007-14AR
Morgan Stanley Mortgage Loan Trust 2007-15AR
Morgan Stanley Mortgage Loan Trust 2007-1XS
Morgan Stanley Mortgage Loan Trust 2007-2AX
Morgan Stanley Mortgage Loan Trust 2007-3XS
Morgan Stanley Mortgage Loan Trust 2007-4SL
Morgan Stanley Mortgage Loan Trust 2007-5AX
Morgan Stanley Mortgage Loan Trust 2007-6XS

Morgan Stanley Mortgage Loan Trust 2007-7AX
Morgan Stanley Mortgage Loan Trust 2007-8XS
Morgan Stanley Mortgage Loan Trust 2007-9SL
Morgan Stanley Mortgage Loan Trust 2008-1R
Morgan Stanley Structured Trust I 2007-1
MSCC HELOC 2007-1
NATIXIS 2007-HE2
New Century Home Equity Loan Trust 2005-1
New Century Home Equity Loan Trust 2005-3
New Century Home Equity Loan Trust 2005-B
New Century Home Equity Loan Trust 2005-C
New Century Home Equity Loan Trust 2005-D
NovaStar Mortgage Funding Trust, Series 2005-1
NovaStar Mortgage Funding Trust, Series 2005-2
NovaStar Mortgage Funding Trust, Series 2005-3
NovaStar Mortgage Funding Trust, Series 2005-4
NovaStar Mortgage Funding Trust, Series 2006-1
NovaStar Mortgage Funding Trust, Series 2006-2
NovaStar Mortgage Funding Trust, Series 2006-3
Park Place Securities Asset-Backed Pass-Through Certificates, Series 2005-WCW1
RALI 2006-QA5 (RALI Series 2006-QA5 Trust)
RALI 2006-QS10
RALI 2006-QS11
RALI 2006-QS17
RALI 2006-QS4
RALI 2006-QS5
RALI 2007-QS1
RALI 2007-QS2
Residential Asset Securitization Trust 2005-A1
Residential Asset Securitization Trust 2005-A12
Residential Asset Securitization Trust 2005-A13
Residential Asset Securitization Trust 2005-A16
Residential Asset Securitization Trust 2005-A6CB
Residential Asset Securitization Trust 2005-A7
Residential Asset Securitization Trust 2006-A1
Residential Asset Securitization Trust 2006-A12
Residential Asset Securitization Trust 2006-A2
Residential Asset Securitization Trust 2006-A3CB
Residential Asset Securitization Trust 2006-A4 (previously Residential Asset Securitization Trust 2006-A4IP)
Residential Asset Securitization Trust 2006-R2
Residential Funding Mortgage Securities (RFMSI), 2003-S6
Residential Funding Mortgage Securities (RFMSI), 2006-S6
Residential Funding Mortgage Securities (RFMSI), 2007-S7
SAST 2005-1
SAST 2005-2

SAST 2005-3
SAST 2005-4
SAST 2006-1
SAST 2006-2
SAST 2006-3
SAST 2007-1
SAST 2007-2
SAST 2007-3
SAST 2007-4
Sequoia Mortgage Trust (SEMT) 2005-1
Sequoia Mortgage Trust (SEMT) 2005-2
Sequoia Mortgage Trust (SEMT) 2005-3
Sequoia Mortgage Trust (SEMT) 2005-4
Sequoia Mortgage Trust (SEMT) 2007-1
Sequoia Mortgage Trust (SEMT) 2007-2
Sequoia Mortgage Trust (SEMT) 2007-3
Sequoia Mortgage Trust (SEMT) 2007-4
Wells Fargo MBS(WFMBS), 2006-AR13
Wells Fargo MBS(WFMBS), 2006-AR3