

U.S. Residential Mortgage Special Report

Changing Loss Mitigation Strategies for U.S. RMBS

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Related Fitch Research

- Special Report, "Impact of Financial Condition on U.S. Residential Mortgage Servicer Ratings," March 26, 2007.
- Special Report, "U.S. Residential Mortgage Servicer Bankruptcies, Defaults, Terminations and Transfers," April 24, 2007.
- Special Report, "U.S. RMBS Servicer Workshop," May 18, 2007.
- Criteria Report, "Rating U.S. Residential Mortgage Servicers," Nov. 29, 2006.
- Special Report, "Examining Home Price Inflation and Residential Mortgage Foreclosure Rates," May 24, 2007.
- Press Release, "New RMBS Criteria Reflects Impact of Loan Modifications," June 4, 2007.

■ Summary

Servicers of U.S. residential mortgage-backed securities (RMBS) products face numerous challenges, many of which have been highlighted by the rapid downturn within the subprime sector. This report focuses on conditions today in subprime, in which proactive, creative collection and loss mitigation strategies are needed. However, it is important to acknowledge that these conditions have the potential to affect servicing practices in other mortgage products as well.

The volume of defaulted loans in subprime portfolios has exceeded the expected levels for this product, and with the number of adjustable-rate mortgage (ARM) loans still moving into the reset phase, this number will increase unless an aggressive stance to work out these cases is adopted. This report does not delve specifically into the reasons for these increased defaults, except as they affect the timing and/or opportunities available to the servicer to develop workable solutions.

Rapidly increasing volumes in default and foreclosure, as well as real estate owned (REO) assets, present servicers with challenges that must be addressed on several fronts. These increases require servicers to quickly reassess their tools, staffing, training, timelines and vendor relationships. As this problem is faced by all participants simultaneously, the ability to hire experienced staff and add new or expand existing vendor relationships will be stressed by market competition for these individuals and services. In addition, the ratio of default to performing loans and the cost to provide multiple opportunities for borrowers and to obtain the information needed to make and document decisions will greatly affect the servicer's overall cost to service.

In the first quarter, Fitch conducted a survey of loss mitigation practices and the results or effectiveness of these practices and, where appropriate, has indicated the results of this survey. In today's servicing environment, Fitch Ratings, as well as many other market participants and regulators, are focusing on a servicer's ability and willingness to

work with borrowers to maintain homeownership. Many borrowers are in homes or have mortgages that severely stretch their budgets. Declining home values and tightening credit standards on new originations have reduced refinancing opportunities for many borrowers. This results in more borrowers needing either alternate work-out strategies or assistance in removing themselves from the situation. RMBS loan modifications, which have been used infrequently in the past, are one possible solution and are discussed extensively in this report.

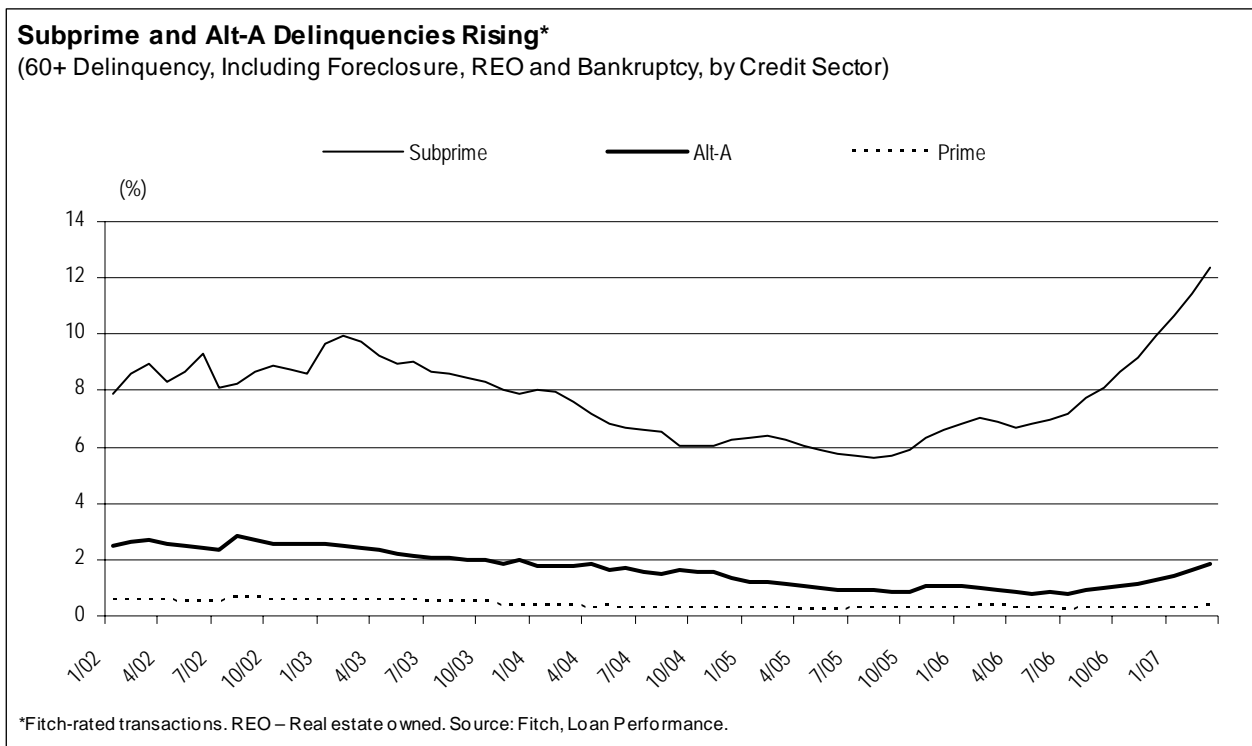
Loss mitigation includes servicing practices that work with borrowers to keep their home or to assist them with the sale of the property. Foreclosure liquidation is generally seen as the least beneficial option. However, as the servicer is responsible to RMBS investors to minimize losses and, therefore, maximize returns, foreclosure may be the only recourse. Fitch believes that if loss mitigation strategies are aggressively pursued, decisions are made based on the best information possible and all parties are informed through proper reporting, both borrower and investor objectives can be addressed.

June 4, 2007

■ Background

Servicers have long relied on a variety of loss mitigation techniques when working with defaulted borrowers. None of the methods used today are new to the industry. They were developed to assist borrowers who have experienced a personal or financial hardship to retain their homes, as well as to improve the cash flow to the owner of the loan asset. As with most other features in U.S. residential mortgage servicing being used for RMBS loans, these practices have been utilized for many years for Department of Housing and Urban Development (HUD) loans, as well as Fannie Mae and Freddie Mac assets. Each of these entities has specific parameters and instructions for use in loss mitigation activities, which they update as the market conditions change. Because many of the same servicers of subprime RMBS pools also service conforming products for these entities, the servicers are very aware of these requirements.

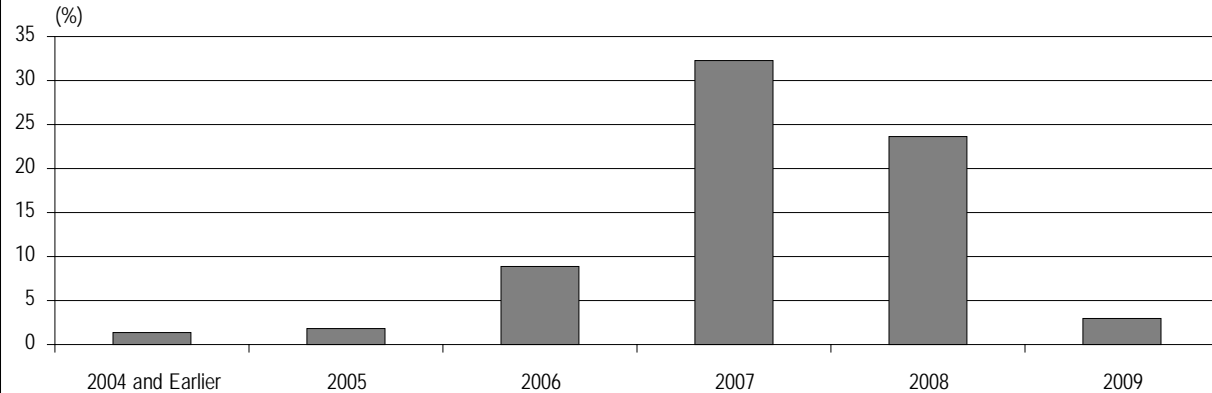
However, there are substantial differences in the products, guidance or lack of guidance, restrictions and triggers found in RMBS pools and transaction documents. Some of the product features found in recent subprime mortgages are factors that increase the risk level for these products. These include qualification at a lower initial rate on ARM products (which may result in payment shock at reset); high loan-to-value ratios (LTV) or piggyback loans; stated income; lower FICO scores; and/or combinations of these risk factors. While subprime products have made it possible for many borrowers who otherwise would not have qualified to obtain financing, these products have a higher risk of default. In a market with stable interest rates and increasing home price inflation (HPI), many of these risks can be mitigated by the borrower's ability to access financing or to refinance out of these programs or products. However, the current situation finds that the HPI in many markets has dramatically slowed or is declining. (Please see Fitch's special report, "Examining Home Price Inflation and Residential Mortgage Foreclosure Rates," dated May 24, 2007). In addition, lenders have, in response to regulatory and market pressures, tightened their underwriting standards, removing many of the features mentioned above, resulting in reduced ability for borrowers to refinance out of their current difficult situation.



The primary document governing the servicer's actions is the pooling and servicing agreement (PSA). These agreements can vary greatly from one product or issuer to another, but for most servicing practices, they generally

Subprime ARM Resets Yet to Come

(First Reset Date as % of Subprime Outstandings)



Source: Fitch, Loan Performance.

rely on statements such as “accepted servicing standards” or that the servicer conducts its activities on these loans as it would for its own loan assets. However, in some instances, certain loss mitigation activities may be limited or prohibited in the PSA. These restrictions, if included, are most often in regard to modifications or determination of default or, more specifically, determination of “reasonably foreseeable” default. There are other important considerations involved with servicing within the requirements and restrictions of the PSAs with regard to modifications. These include those imposed by the Real Estate Mortgage Investment Conduit (REMIC) code (the REMIC sections of the Internal Revenue Code of 1986), accounting issues deriving from Financial Accounting Standards Board (FASB) 140 rules, the feasibility of amending existing PSA language to allow modifications in various transactions, developing best practices for determination of the most appropriate plan and reporting of modifications in monthly reports to trustees. There are currently several industry participants working to determine recommendations and guidelines for many of these issues, including the American Securitization Forum (ASF) and the Mortgage Bankers Association (MBA).

■ **Operational Impact of Increased Defaults and Loss Mitigation Efforts**

Higher defaults, as well as anticipated defaults expected due to the volume of upcoming ARM resets, require an increase in loss mitigation proficiency and staffing. Servicers have recognized and anticipated that proactive borrower contact, increased staffing and outsourcing, and vendor and timeline management are just some of the areas of concern. In addition, low home price appreciation, tightening credit standards on new originations and higher levels of regulatory and legislative scrutiny may also hamper servicer strategies to manage or reduce defaults and deal with increasing costs. Decreases in origination volume change the ratio between performing loans and nonperforming loans, which will stay in transactions longer and result in higher long-term costs to service.

Each of the items discussed below have a direct impact on the servicer’s cost to service by requiring additional staff or technology expenditures, increased costs of vendor services, carrying cost of advances, and development and performance of initiatives outside the normal expected scope of activities for a residential servicer. The servicers of subprime loans closely monitor and manage their cost to service and have indicated that, for the most part, they expect the current servicing fees in transactions to cover their increased costs. However, Fitch believes this is an area of concern for certain servicers who either do not have a diversified portfolio or who are not continuing to take in new production, which would improve the ratio of performing to nonperforming loans. This concern could also arise upon the need to transfer a subprime portfolio that contained high default levels, as the number of servicers willing to take on this servicing at current fee structure levels could be limited.

Proactive Borrower Contact: In preparation for the number of ARM resets that require proactive borrower contact, servicers are being pressed to identify and implement more aggressive loss mitigation opportunities and solutions to keep subprime borrowers from becoming delinquent or moving into higher delinquency stages. Contact prior to actual default is necessary to determine imminent default prior to the reset date. However, servicers have expressed an increased difficulty in contacting borrowers, finding that phone calls and letters were less effective in reaching the correct individuals. Some servicers have stated they are finding that borrowers are becoming less cooperative and going to foreclosure in increasingly higher numbers without speaking with the servicer.

In today's environment, servicers are developing or revisiting some of the tools they may have used in prior high-default cycles. Servicers have reassessed their calling campaigns, cycles, and inbound and outbound hours of operations. Some servicers have indicated that, in certain hard-hit markets, they are returning to efforts such as "door knocks" or flyers left at the individual properties in an effort to reach out to the borrowers who have not responded to standard processes. A few servicers have indicated they are, or are looking into, partnering with local consumer groups to facilitate contact with borrowers or using their attorneys to make loss mitigation offers. However, all servicers agreed that consistent treatment of all borrowers is critical.

Staffing and Outsourcing: Most subprime servicers have indicated they are preparing for significant increases in default and modification volume. They have, in several cases, identified senior loss mitigation agents to be trained on recently developed or refined modification procedures. Servicers are utilizing staffing models to project needs and are hiring collectors and loss mitigation staff ahead of the curve as best they can. Many servicers use a call center approach, recognizing that a customer service call also presents an opportunity for proactive loss mitigation contact. However, servicers have indicated that using customer service or early collection staff requires significant cross-training so that all potential opportunities to identify loss mitigation needs are identified.

With the reduction of ancillary fee income and increases in cost to service, driven mostly by increases in defaults, servicers have focused on finding efficiencies and ways to control costs whenever possible. While debate among servicers continues, many recognize the potential for reducing costs through outsourcing offshore. Generally, most servicers agree that management and communication are fundamental to successful outsourcing, whether it is offshore or domestic. Servicers have also noted that outsourcing remains a commodity best measured through definable quality and performance metrics and that the ultimate responsibility for outsourced processes remains with the servicer.

Tools: Prior to executing a loss mitigation plan, servicers must perform a detailed analysis of available work-out options in comparison with foreclosure. It is important that the servicer take steps to effect and document that they are consistently applying all work-out options fairly among borrowers. Technology has typically been a critical tool used to support the various levels of analysis and has enhanced productivity and controlled costs. Most, if not all, subprime servicers rely on effective call management tools, such as dialers, voice response units, Web payment functionality and management oversight ability and controls.

Servicers have typically developed technology tools to facilitate default processing with models and applications designed to prepare calculations, compare scenarios and perform a detailed/documented determination of borrower acceptability to provide consistency of loss mitigation decisions among borrowers. Further enhancements to existing tools and analysis of the best automated decision support systems available for various purposes will keep loss mitigation strategies current and provide reliable benefits to both the borrowers and certificateholders.

Timeline and Vendor Management: The multiple work-out scenarios and opportunities currently being offered to borrowers will cause timelines to be extended beyond the ranges typically accepted in the market. The prolonging of foreclosure and, ultimately, liquidation can lead to higher carrying costs and increased exposure to potentially steeper market value declines. In an effort to avoid this potential situation, most servicers today continue to pursue a dual strategy of initiating foreclosure within a legal framework while working with the borrower to return the loan to performing status. However, some servicers have indicated they are delaying the foreclosure notice in more cases, working to execute another option even if earlier efforts failed. Also, a few servicers have indicated they are

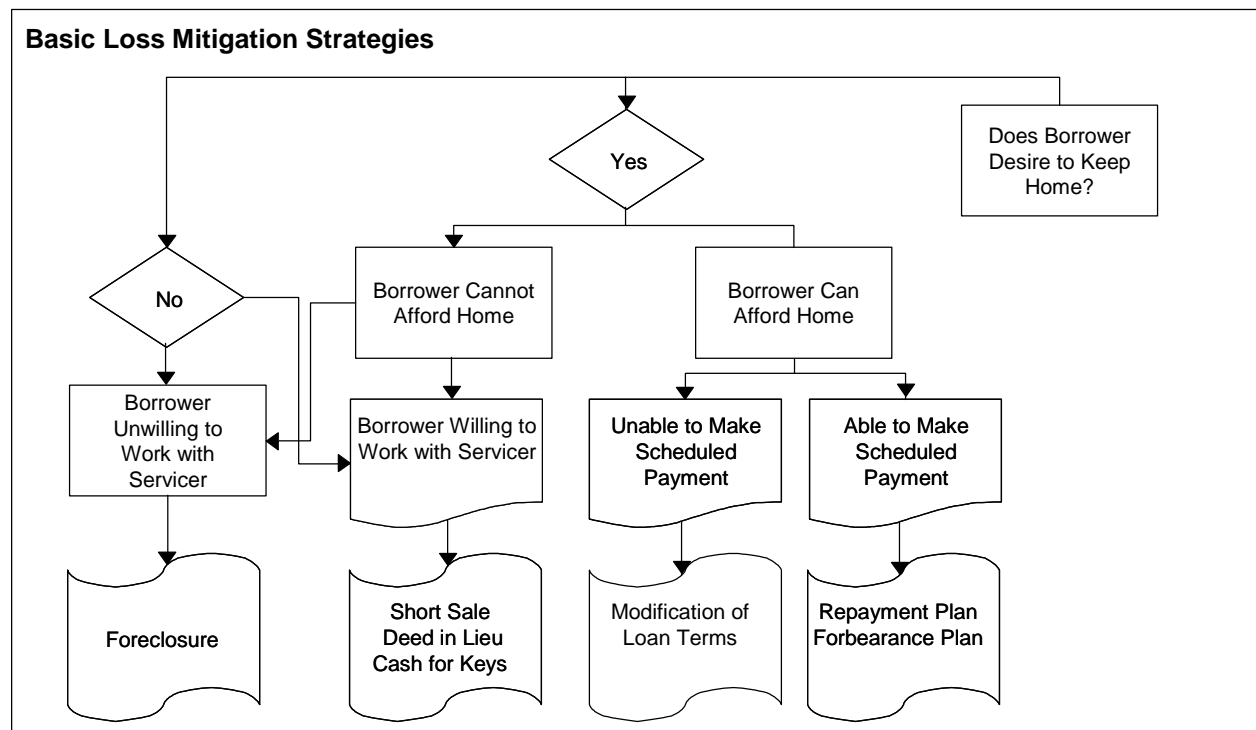
working more closely with local consumer groups or their attorneys to initiate a solution prior to the legal proceedings, which, again, may have the effect of delaying the filing beyond typical established timelines.

Servicers have also noted that they believe there will be longer foreclosure timelines on the horizon due to the increased volume of filings and repeat actions required after multiple efforts with borrowers. In addition, increased foreclosures are causing delays with county recorders, broker price opinion (BPO) providers, property inspection and preservation vendors and REO networks. Some servicers have indicated that vendors and, particularly, attorney networks may be adversely affected by increased foreclosures, property preservation and inspection orders, and REO listings, noting that vendors must also increase their ranks with experienced staff. In addition, local jurisdictions and courts are becoming backlogged and overloaded with foreclosure cases, which have negatively affected foreclosure timelines and translated into higher costs to carry.

Most Fitch-rated servicers have strict timeline adherence policies and clearly delineated options. However, ultimately, servicers have agreed that current measurements for foreclosure and REO liquidation timeline management will need to be closely monitored and reset as the market reacts to the pressure of quickly changing volumes.

Reporting Process: The majority of servicers have the ability to capture and report information regarding loss mitigation scenarios and modifications. However, some servicing systems and reporting routines may require enhancements to capture and report data for multiple plans and scenarios. For servicers who do not currently have the functionality to track and report on features such as separate performance and cash flow effects of modifications, this could be a major systems initiative and require significant increases in technology costs to support these increased loss mitigation efforts.

For Fitch-rated servicers, we receive and analyze data regarding loss mitigation strategies, default levels and timelines typically three times per year. This information can, and has been on occasion, increased to a monthly reporting cycle if Fitch feels that closer monitoring of a servicer is warranted.



■ Loss Mitigation Strategies

The main objective of a servicer's loss mitigation strategy should be to avoid or minimize losses by identifying and soliciting potential candidates for a loan workout as early in the default process as possible. The servicer must fully understand the reasons and extent of the problem. Before the servicer can develop the correct strategy, they will determine whether the borrower is experiencing a temporary financial hardship, as opposed to one who is unable to afford the home. If a servicer can ascertain a genuine desire and ability of the borrower to avoid foreclosure and retain their home, an effective work-out plan can often prevent liquidation of the loan and lessen the effect on the borrower, as well as losses incurred by the RMBS pool.

There are several work-out options that servicers can pursue depending on the borrower's circumstances and the seriousness of the delinquency. Typically, the early-stage collections, considered to be either 30 days or up to 60 days delinquent by some servicers, are handled by collectors who are specifically looking for payment of the past-due amount or a promise to pay by a set date. However, good loss mitigation management starts with the training and effective monitoring of early collection staff in the ability to identify problem situations, which should be immediately referred to staff with loss mitigation expertise.

Repayment plans and forbearance plans continue to be the most widely used loss mitigation strategies. All servicers use these tools and have reported continued success with them. However, the plans, number of plans for one borrower and the length for repayment are adjusted to specific situations and market conditions. With subprime borrowers, servicers have reported an increase in the need for repayment plans and less success in borrowers staying on the plans, which creates a need to reset or develop new schedules. This increases the need for clear documentation of repayment plans, broken plans and plans to one borrower, which should be used when determining the appropriateness of continuing this strategy or moving on to a more severe option.

The responses to the recent survey indicated that subprime servicers are using plans to resolve defaults on average in a range of 50%–75% of the cases. However, it should be noted that most servicers indicated that repayment and forbearance plan effectiveness is decreasing. It also should be noted that neither plan is expected to work for the borrowers facing ARM resets, as many of the borrowers are expected to default upon reset because they will not be able to afford the new monthly payments.

Repayment Plans

Collectors will discuss the borrower's situation, reasons for default and financial condition, and when the situation allows, a repayment plan is established. A repayment plan allows a borrower whose circumstances are temporary in nature to repay, usually only two to three missed loan payments, over a set period while concurrently making their timely monthly mortgage payments, preventing the loan from becoming more delinquent. The arrangement exposes the pool to minimal losses, if any, since the loan is made whole and the borrower is returned to a performing loan status. Typically, repayment plans are made on an informal, verbal basis, whereby a promise-to-pay schedule is agreed upon by the borrower and servicer.

The repayment plan terms have typically been 3–6 months; however, servicers have reported that plans are trending longer, so servicers are now establishing extended periods, in some cases as much as 12–24 months. The longer time frames allow borrowers to reinstate, even when they have limited funds, by reducing the amount of additional monthly outlay.

Since the basis of a repayment plan indicates a strong likelihood of recovering the missed payments, the servicer is required by the PSA to continue advancing payments until the borrower is brought current. Loans on a repayment plan should be counted and categorized in the appropriate delinquency category until the borrower becomes fully current on the loan.

As the seriousness and possible time required to work out a loan increases, so does the need to obtain additional information about the borrower and the property. A financial evaluation of the resolution strategy will need to be

conducted either before the acceptance of a forbearance plan or, in some cases, an extended repayment plan. Effective servicers typically utilize sophisticated decision-making technology to calculate net present values and compare the financial outcome of the resolution strategy with that of other work-out solutions and foreclosure. The plan that produces the most optimal solution and minimizes losses, while falling within the parameters of both the borrower's circumstances and the PSA, would be selected.

Forbearance Plans

A forbearance plan is generally a more formal agreement and allows borrowers who have missed several loan payments due to the occurrence of a major life event, such as a disaster, illness or job loss, to repay missed payments while concurrently making their timely mortgage payments. While similar to a repayment plan, a forbearance plan typically involves a more delinquent status and, therefore, could take a longer time to recover the missed payments. The agreement should be formally documented and signed by the borrower since the servicer will be required to hold off or stay the foreclosure proceedings during the term of the plan.

As with the repayment plan, since the basis of a forbearance agreement indicates a strong likelihood of recovering the missed payments, the servicer is required by the PSA to continue advancing payments until the borrower is brought current. Loans on a forbearance plan should be counted and categorized in the appropriate delinquency category until the borrower becomes fully current on the loan.

Current product and market conditions have resulted in increased discussions and the use of modifications in RMBS transactions and have fueled anticipation that usage will expand significantly. As discussed previously, the determination of acceptability for a servicer to perform modifications within the parameters of the RMBS structure and PSAs is being debated on several fronts. The final acceptability and extent to which modifications can be used is yet to be determined. However, in researching the anticipated volume of subprime borrowers facing reset dates within the next few months, several servicers have determined that many borrowers will not be able to afford the adjusted payment and will not be able to refinance. For these borrowers, most servicers believe modification may be the best and possibly the only option remaining in order to keep these borrowers in their homes.

For the purpose of this report, Fitch is taking the view that modifications within RMBS transactions are permitted and, as such, the focus is more on the processes and controls around the strategy than offering an opinion on the legality of the strategy itself. As stated, Fitch expects each servicer, with the counsel of their legal staff and accountants, to make an independent assessment and determination of the use and type of loss mitigation strategies allowed within their portfolio. However, based on projections from servicers, Fitch believes that over the next 12–18 months, modifications could be used on as many as 5%–10% of the loans, based on the original outstanding balance of the deal, and could be the only viable loss mitigation strategy for as much as 40%–50% of the loans in default or determined to be a reasonably foreseeable default scenario.

As expected, the survey indicated limited usage of modifications in most servicers' loss mitigation programs. However, as anticipated, the use of modifications is steadily increasing within several of the portfolios. The range of modifications in transactions was from a very modest amount of less than 1% up to an increasing range of 10%–20%. As some of the existing transactions already contain provisions for modification of loans, there is some history regarding the redefault rates on modified loans. The servicers who had the most experience with loan modifications indicated the redefault rate for modifications has been in the 35%–40% range, based on an admittedly small number of modifications completed to date. However, most servicers indicated they expect that this redefault rate could increase, again due to current market conditions.

Along with consideration of a borrower's willingness and ability to maintain homeownership, the ultimate loss to the transaction must be considered in determining the execution of the best loss mitigation strategy. By using best execution calculations (lowest loss to transaction based on current value of property, as compared with foreclosure and liquidation loss, determined using periodic updates of actual costs by area) applied on a consistent, documented basis, the actions of the servicer should be defensible to the consumer, their advocates and investors.

There are few specific rules regarding the process or selection of which type of modification works best in certain scenarios. However, there are several practices that Fitch is working with others to promote and believes will become best practices. These practices include reasonable and diligent selection, analysis, documentation and decision of modification type to be used. Also of importance is the standardization of reporting of modifications in the transaction structure.

Loan Modifications

Loan modifications allow for one or more of the terms of the mortgage to be changed, including interest rate and principal reductions, forgiveness of loan payments, extensions of loan terms or capitalization of unpaid amounts. Modifications are a viable alternative to foreclosure; however, as with foreclosures, modifications can directly affect the RMBS pool's cash flow, although to a lesser degree if the modification is successful. In addition, a loan modification can result in a loss and subsequent charge to the RMBS pool's credit enhancement due to a partial claim. However, the servicer may choose to modify a loan because the loss arising from the modification will be less than the potential loss of foreclosing and liquidating the property.

Selection: Defaulted loans and loans for which the servicer has determined are in reasonably foreseeable default, such as ARM loans prior to reset dates where the borrower cannot afford the increased payment, would be selected for modification based on a specific set of criteria. Most servicers use default decision technology to calculate net present values and compare the financial outcome of a particular resolution strategy to that of other work-out solutions and foreclosure. Consistently applying these tests and maintaining the results should provide the servicer with proof that it is making fair and unbiased decisions, thereby satisfying consumers, advocates, regulators and investors.

Analysis: When determining the type and extent of modification, the servicer will need to determine the payment amount the borrower can afford and that there is a strong likelihood of repayment. If neither condition is considered or present, the servicer may be delaying an inevitable foreclosure, thereby increasing losses. Whether considering a rate reduction, balance reduction, capitalization of amounts due or forgiveness of debt, the servicer should limit the structure of the modification to the extent absolutely required to work for the borrower. If these fall under the current market rates or current value of the property, strong compensating factors would be needed to justify the modification.

If the loan modification is for an ARM loan, the servicer should closely review the decision as to whether to make the rate adjustment a temporary or permanent change. If the borrower's circumstances can be addressed using a temporary solution, such as extending the fixed period of the note for an additional year or possibly two years, the result would potentially be more positive for the trust. However, if this is the case, the servicer would need to establish a procedure to ensure the loan would be readdressed and reassessed at the appropriate time in the future.

Many servicers feel a trial modification (mod) term will allow the borrower to show their willingness and ability to make payments under the new terms. Trial mods or stipulation (stip) mods will also prove beneficial in saving the trust additional expenses if it is shown that the borrower cannot perform as expected.

Documentation: Both the selection and analysis will be ineffective if the servicer is not using updated financial and property information to assess the borrower situation. This documentation should be retained as evidence of the decision. Market and borrower situations change, so this information should be updated based on a set procedure. Fitch believes that information obtained at loan origination should not be the only documentation used in assessing a borrower's income, assets or equity in the property.

Decision: As with all decisions that result in a loss to the trust, the servicer should have an established decision process in place to determine that all procedures have been performed in accordance with the company's guidelines and that an experienced staff member has been consulted and concurs. Most servicers agree that a modification should be a one-time occurrence. If subsequent modifications are permitted, the benefit derived from modifying the loan is skewed by losses taken previously.

If the loan has mortgage insurance (MI) coverage, the servicer would be expected to involve the MI company as part of the decision process by obtaining concurrence on proposed actions. If the MI company requested additional reporting or updates to maintain its policy coverage, the servicer would be expected to set up a process to mitigate any instance or failure, which might cause a claim to later be denied or curtailed.

Monitoring and Reporting: There is no adequate historical data on which to base projections of the redefault rate for loans that have been modified or the effect these will ultimately have on the losses within the RMBS pools. Therefore, it is very important that servicers accept and endorse the request for this information from the various parties. The industry is being asked to accept the belief that the servicers can and will adequately manage and affect procedures that will impact not only the lives of the homeowners but also the return on investments for many investors. Fitch believes one way servicers can demonstrate they are proactively managing this process is to develop and adhere to a reporting standard, which would allow all interested parties to measure the effectiveness of these actions. (Please see Appendix A for additional statements on modification reporting.)

Strategies that Result in Loan Liquidation

Servicers have indicated that as little as one year ago, refinances resulting in full payoffs were used most frequently for ARM resets and as a loss mitigation tool for defaulted loans. Today, refinance is not an option for many subprime borrowers due to tightened guidelines and flat or declining home price appreciation. Further, third-party and short sales, which resulted in some losses, although minimal due to some home price appreciation, are now less effective due to concerns on ultimate value in many markets and, while still less costly than REO liquidation, are seeing dramatically higher losses.

When the servicer determines that a borrower simply cannot afford the home, either because they have overextended themselves or their long-term financial outlook has changed, the best resolution is to work with the borrower to sell the property, removing the borrower's responsibility on the loan and repaying the trust. However, in the current environment, the home may not be valued at an amount sufficient to cover the outstanding principal balance, especially since there may be additional liens on the property. In this case, the servicer should rely on their determination of the current property value to establish pricing.

In the survey, servicers indicated that short sales and deeds-in-lieu continue to be active loss mitigation strategies. Of note is the large variance in the usage of short sales and deeds-in-lieu among the servicers that were surveyed, ranging from the low single digits up to 35%–45%. Many servicers also indicated these numbers were increasing. As the price at which a short sale is offered adjusts with the movement of the property value, the loss percentage for this type of workout will increase. However, the cost savings over foreclosure and REO liquidation, as well as the continuing potential downside in market values, are expected to continue to make this option preferable to other liquidation scenarios.

Short Sale

In instances where the borrowers acknowledge they cannot afford to stay in their home, the servicer may assist with the liquidation of the property. As an alternative to foreclosure and the REO sale process, a short sale allows for the property to be sold by the borrower at an amount less than the full payoff of the loan. The short payoff is agreed to by the servicer, who releases the borrower from the lien and any potential subsequent claims for loss. The borrower must demonstrate an inability to afford the home and a lack of assets to make up the difference between the payoff amount and the actual sales proceeds. The difference plus other expenses are charged to the trust and the asset is liquidated from the trust.

Short sales (or discounted payoffs) reduce or eliminate foreclosure and liquidation expenses, shorten the length of time to liquidate the property and reduce the potential for future market value declines. Short sales may be the best liquidation option for the trust and the borrower inasmuch as there is no eviction process, no REO to manage and liquidate and the trust incurs a one-time loss (there are no further costs and expenses to maintain and liquidate the property). Toward that end, the servicer would set the sales price to reflect the true value of the property based on a full internal and external inspection of the property.

In cases where there is not an option to execute a short sale, the servicer may still be able to obtain a deed-in-lieu of foreclosure. This strategy still requires the participation of the borrower and has the possibility of saving time as well as the expense of completing the foreclosure process, which can take up to 12–24 months in some states.

Deed-in-Lieu of Foreclosure

In lieu of going through the formal foreclosure process, the servicer may agree to accept the deed on behalf of the trust and continue with the liquidation of the property. The deed-in-lieu option does not prevent the trust from incurring liquidation expenses and potential future market value declines, but rather it reduces foreclosure and eviction costs and timelines, which can be extensive in certain states. As with a short sale, the servicer must confirm the full value of the property in addition to obtaining definitive evacuation conditions (e.g., that the home has not been damaged in the interim).

As with all REO liquidations, the difference between the sales proceeds and the loan balance plus carrying costs and other expenses are charged to the trust as a realized loss.

Cash for Keys

In conjunction with either a deed-in-lieu of foreclosure or the eviction process, the servicer offers the borrower a small sum of money to help with moving costs or making a down payment for a rental residence in exchange for vacating and/or deeding the property to the servicer on a timely basis. Servicers should determine that amounts disbursed to the borrower are well within the time savings provided by avoiding foreclosure and eviction and definitive conditions and timelines are met to evacuate the property.

A servicer may also offer cash to the borrowers to shorten the eviction process even after they have completed the foreclosure process. Although this does not have the same effect as avoiding the foreclosure process itself, the savings in eviction time and expenses can be considerable in some states and under certain circumstances. In addition, the ability to require the property be left in good condition (avoiding damage/vandalism and requiring broom-swept condition) can save considerably in time and expense.

Cash paid to borrowers is included as a liquidation expense, which is passed through to the trust and charged to credit enhancement as part of the final claim.

■ Impact of Modifications on Securitization

Fitch has long been of the opinion that loan modifications are an important part of any mortgage servicer's toolset for limiting losses on defaulted mortgages. Successful loan modification programs can unquestionably benefit investors in RMBS through maximizing cash flows and reducing losses. In recent research publications, Fitch has discussed the challenges facing servicers and analyzed loan modification practices (please see Related Fitch Research on page 1).

While Fitch recognizes the value of loan modification programs, the extensive levels of modifications that some servicers are contemplating and that others have already initiated presents new challenges in analyzing the credit risk of securitizations. Varying practices with respect to capturing and reporting data on loan modifications make it difficult to track the quantity and characteristics of modified loans. Moreover, the performance of mortgages post modification may vary widely, and the timing and amount of redefault and losses are uncertain.

Loan modifications and subsequent loan performance are also of concern when considering the effectiveness of trigger events designed to prevent overcollateralization (OC) step-down. These trigger events compare delinquency rates to available credit enhancement and, in a trigger event, do not allow enhancement to decline as it would if the ratio were favorable. While there has been much discussion of the effectiveness of the standard trigger language in use today, extensive use of modifications, coupled with the reporting of modified loans as contractually current, presents a new situation. It is now quite conceivable that securitizations with high levels of mortgage default will not

breach delinquency triggers, thus allowing OC to step down. (See “New RMBS Criteria Reflects Impact of Loan Modifications.” June 4, 2007.)

Fitch’s rating opinions on new securitizations will reflect the potential impact of the extensive use of loan modifications. However, Fitch recognizes that many existing Fitch-rated securitizations may release OC despite high levels of mortgage default, if large numbers of modified loans are reported as current. This may, in turn, result in downgrades, depending on analysis of available credit enhancement and forecasted levels of redefault. However it must be stressed that more severe rating actions would possibly be necessary if modifications were not made.

While changes to the documents of existing deals are difficult, servicers may find they have some discretion under the documents as to when and if to report a modified borrower as current, thus achieving similar protection as that for new deals.

Fitch believes modifications may be a useful loss mitigation technique when appropriate policies and procedures are in place and, therefore, could minimize expected losses on a pool. However, Fitch believes the ability of the servicer to administer and report modifications, as well as the type of modification, may present additional risks to a transaction. A servicer’s use of unlimited modifications or modifications without appropriate controls could result in additional losses and downgrades.

■ Addendum A.

Reporting for Modifications

Reporting on modified loans is currently being discussed by several parties in the industry, and recommendations as to the format and content of monthly reports to the trustees are expected to be developed. Initial indications are that parties are working to make the reporting requirements for both new and existing transactions conform to a standard with which Fitch believes all servicers should be able to comply.

In addition to the monthly reporting to the trust, Fitch will expect servicers to provide certain additional statistics as part of our servicer rating program. These will include items such as multiple modifications to one borrower and details regarding the type of modification used, such as ARM to fixed, extended fixed period on ARMs, capitalization of payments, balloons, forgiveness of debt, etc. In addition, below is a sample chart which will be needed to determine the effectiveness and performance of modifications over time and should be provided by any servicer who uses modifications as a loss mitigation tool in RMBS.

Sample of Statistics to be Requested from Servicers using Modifications as a Loss Mitigation Tool:

Performing Modifications

<u>Months Since Mod</u>	<u>Loan Count</u>	<u>Principal Balance at Mod</u>	<u>Projected Loss without Mod</u>	<u>Cost to Trust of Mod</u>	<u>Cash Collected at/after Mod</u>	<u>Net Value to Trust after Mod</u>
< 3						
3-6						
6-12						
> 12						
Totals						

Redefaulted Modifications

<u>Months Since Mod</u>	<u>Loan Count</u>	<u>Principal Balance at Mod</u>	<u>Projected Loss without Mod</u>	<u>Cost to Trust of Mod</u>	<u>Cash Collected at/after Mod</u>	<u>Value of Lost Time to Liquidate</u>	<u>Net Value to Trust after Mod</u>
< 3							
3-6							
6-12							
> 12							
Totals							

Note: Statistics should indicate all mods since program began for RMBS. Tables should be developed by product and transaction

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