



## American Securitization Forum

### Discussion Paper on the Impact of Forborne Principal on RMBS Transactions

June 18, 2009

#### I. Introduction, Purpose and Assumptions

Many mortgage loan modification programs, including the Obama Administration's HAMP program, employ principal forbearance as part of a waterfall of loss mitigation options to reduce a borrower's debt-to-income ratio ("DTI"). Principal forbearance generally refers to situations where a lender agrees to allow the borrower to pay a portion of a loan's principal balance on a later date. In almost all cases, a principal forbearance does not accrue interest and is added as a balloon payment to be paid on the loan's maturity date. The proper way to account for forborne principal in residential mortgage-backed securities ("RMBS") transactions is not entirely clear, as most pooling and servicing agreements (each, a "PSA") do not specifically address this unforeseen issue. This lack of clarity has given rise to differing views from market participants on how to treat principal forbearances. Some market participants would prefer the forborne amount to be allocated as a realized loss at the time of the modification, while others would prefer the forborne amount to not be allocated as a realized loss unless the loan is liquidated without recovery on the forborne principal.

The American Securitization Forum (the "ASF")<sup>1</sup> is releasing this white paper to explain the effects of principal forbearance on the cashflows of the two most frequently used structures in the RMBS industry: the shifting interest structure and the overcollateralization structure. It should be noted, however, that RMBS structures vary from deal to deal and issuer to issuer and it would be impossible to cover every PSA iteration in this piece. For ease of discussion, we have assumed a hypothetical transaction with one loan group containing pro-rata pay senior certificates and sequential pay subordinate certificates. We have also assumed that there were no unscheduled payments made or principal or interest losses incurred beyond what is included in the scenarios below. Furthermore, explicit provisions relating to modifications of mortgage loans are a relatively new addition to the PSAs that govern each RMBS transaction. Certain agreements did not permit modifications and the ones that did were generally not explicit on how to account for modifications when calculating payments and losses on the certificates. Because

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<sup>1</sup> The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 380 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. The ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to [www.americansecuritization.com](http://www.americansecuritization.com). ASF is an independent affiliate of the Securities Industry and Financial Markets Association (SIFMA).

of this inconsistency and lack of clarity, the descriptions below are further based on the following two additional assumptions: (i) the PSA in question actually permits forbearances and other types of modifications and (ii) the principal forbearance concept has been appropriately incorporated into the PSA so as to address the fact that the borrower's monthly payment has been reduced.

## **II. The Impact of Principal Forbearance**

The effects of allocating principal forbearance either at the time of modification or at the time of liquidation depend on the type of RMBS transaction. There are two basic types of cashflow structures for RMBS transactions: "shifting interest" and "overcollateralization" ("OC"). Shifting interest structures are generally used for securitizations involving "prime" mortgages and OC structures are generally used for securitizations involving "subprime" mortgages.<sup>2</sup> Generally, both of these structures consist of classes of senior certificates and subordinate certificates. The subordinate certificates are subordinate to the senior certificates in that they are paid after the senior certificates and they absorb realized losses prior to the senior certificates. PSAs generally define "realized losses" as the difference between the unpaid principal balance of a loan and the proceeds received on that loan when it is liquidated.<sup>3</sup>

The main difference between shifting interest and OC structures is the amount of mortgage loans included in the trust compared to the amount of certificates issued by the trust. In a shifting interest deal, the aggregate principal balance of the mortgage loans equals the aggregate principal balance of certificates issued. However, due to the lower credit quality of subprime loans, the aggregate principal balance of mortgage loans in an OC structure is generally greater than the aggregate principal balance of certificates issued<sup>4</sup> and the difference between the two is called the "overcollateralization amount" (or "OC amount"). The overcollateralization amount for each deal is typically certificated and it represents the first-loss piece of the securitization, providing increased subordination to the other classes of certificates. In both structures, subordination is one of the main factors considered by rating agencies in assigning ratings to the certificates.

### *Effects on Shifting Interest Structures*

As noted above, the aggregate principal balance of the certificates issued in a shifting interest structure will equal the aggregate principal balance of the underlying mortgage loans. This parity creates a "dollar for dollar" concept where all principal and interest received on the loans will equal the principal and interest required to be paid on the certificates. In a typical deal, all payments to the certificates are funded by the "pool distribution amount," which consists of all amounts, both principal and interest, received on the mortgage loans. These interest and principal amounts are commingled in one account to pay the required interest and principal payments on the certificates. Distributions on the certificates are normally made in the following

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<sup>2</sup> Both shifting interest and OC structures are also used in securitization of "Alt-A" mortgage loans, depending on the loans' credit quality. In certain situations, OC structures may also include second lien mortgages.

<sup>3</sup> See Appendix I for specific examples of realized loss definitions.

<sup>4</sup> Excluding the certificate evidencing the OC.

order of priority: (i) interest accrued on the senior certificates, (ii) principal required to be paid on the senior certificates, (iii) interest accrued on the most senior of the subordinate certificates, (iv) principal required to be paid on the most senior of the subordinate certificates and (v) then interest and principal to the next most senior subordinate certificate, and so on (depending on the number of subordinate classes).<sup>5</sup>

Principal payments received on the mortgage loans are classified as either “scheduled” or “unscheduled” payments.<sup>6</sup> Scheduled payments generally refer to those payments that are being made on a schedule, such as the borrower’s monthly payment. Scheduled payments received on the loans are passed-through to the senior and subordinate certificates based upon their senior and subordinate percentages, which are calculated by dividing the aggregate principal balance of the senior or subordinate certificates, as applicable, by the aggregate principal balance of the loans in the pool. In other words, the senior and subordinate percentages represent the pro-rata share of the senior and subordinate certificates in the payments received on the loans. For example, let’s assume a senior percentage of 95% (i.e. the senior classes represent 95% of the pool) and a subordinate percentage of 5% (i.e. the subordinate classes represent 5% of the pool).

Forborne principal affects how principal payments are allocated within the structure. If we assume that the principal forbearance is not allocated as a realized loss at the time of the modification, then the principal balances of the senior and subordinate certificates would remain in the same proportion. In other words, the senior and subordinate percentages would not change until the allocation of a realized loss. As such, scheduled principal payments would be divided on each distribution date among the senior and subordinate certificates on a 95% to 5% basis until a realized loss was allocated. If no other realized loss is allocated, the subordinate certificates would continue to receive the same proportion of principal payments until either the forborne amount was not received at maturity or the loan was otherwise liquidated (and the forborne amount was not recovered). However, if we assume the principal forbearance was allocated as a realized loss at the time of the modification, the subordinate percentage would be reduced as a result of the loss being allocated to the most subordinate class outstanding. If we assume this realized loss reduced the subordinate percentage to 4%, then the senior percentage would be increased to 96%. Scheduled principal payments would then be divided on each distribution date among the senior and subordinate certificates on a 96% to 4% basis until another realized loss was allocated (at which time the senior percentage would increase again). The effect of this mechanism is to pay more principal to the senior certificates when losses begin to accrue on the mortgage loans in the trust. Ultimately, forborne principal being allocated as a loss to the subordinate certificates at the time of modification results in more principal being allocated to the senior certificates and less principal being allocated to the subordinate certificates.

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<sup>5</sup> Distributions on the certificates are made after the servicing fee is paid to the servicer.

<sup>6</sup> As noted in the assumptions, unscheduled payments, which refer to things like prepayments, are beyond the scope of this basic cashflow discussion. Principal forbearance does have an effect on how unscheduled payments are allocated, but the consequences are far less serious than those outlined herein. Generally, the rate at which the senior and subordinate certificates receive unscheduled payments depends on the length of time the deal has been outstanding (seniors receive a disproportionate share in the early stages) and/or certain triggers which occur when delinquent loans or losses on loans reach a certain specified level.

Forborne principal also affects how interest payments are allocated within the structure. If we assume that the principal forbearance is not allocated as a realized loss at the time of the modification, then all of the senior and subordinate classes of certificates would accrue interest on their principal balances for that distribution date. However, the forborne principal amount does not accrue any interest which results in a disruption of the “dollar for dollar” concept. After principal is forborne, the amount of interest accrued on the mortgage loans will be less than what is required to pay interest on the certificates.<sup>7</sup> This disparity between interest accrued on the loans and interest owed to the certificates will ultimately result in the most subordinate class outstanding being shorted some or all of the principal that it is due. Then, because no realized loss is taken, the same problem will occur on each ensuing distribution date. The forborne amount will continue to create a disparity between interest accrued and interest owed until the forborne amount is either paid or realized as a loss to the most subordinate class outstanding. If a loss were taken at the time of the modification, this disparity would not occur because the most subordinate class outstanding would be written down.

All shifting interest transactions contain PSA provisions dedicated to the allocation of realized losses on the certificates. However, certain transactions also contain PSA provisions that further adjust the aggregate certificate principal balance to equal the aggregate “stated” or “scheduled” principal balance of the loans (see Appendix II for examples). Under these provisions, the aggregate certificate principal balance is adjusted by reducing the principal balance of the most subordinate class outstanding based on the difference between the aggregate certificate principal balance and the aggregate “stated” or “scheduled” principal balance of the loans. This type of provision would resolve the problems caused by principal forbearance in the prior two paragraphs if the aggregate “stated” or “scheduled” principal balance to be paid on the loans was, in fact, reduced to account for forborne principal. Whether this reduction occurs depends on whether the definition of “stated principal balance” or “scheduled principal balance” contained in the applicable PSAs (see Appendix I for examples of definitions relating to the provisions set forth in Appendix II) is read to be decreased by the amount forborne.

#### *Effects on Overcollateralization Structures*

As noted above, the aggregate principal balance of the certificates<sup>8</sup> issued in an OC structure will generally be less than the aggregate principal balance of the underlying mortgage loans. The difference between these two amounts is called the “overcollateralization amount”<sup>9</sup> and it acts as credit enhancement to all other classes of certificates. This increased subordination is necessary due to the lower credit quality of subprime loans. In OC structures, more principal and interest is scheduled to be received on the loans than is required to be paid on the certificates, which will

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<sup>7</sup> As an aside, a similar situation would occur after an interest rate modification in a shifting interest fixed-rate deal because the certificate interest rate would remain at a specified fixed rate while the interest rate on the loans would be reduced by the modification. This scenario would not occur in a shifting interest ARM deal because the certificate interest rate is based on the weighted average coupon of the loans.

<sup>8</sup> Excluding the certificate evidencing the OC.

<sup>9</sup> In most deals, the overcollateralization amount remaining after it is used to cover any principal and interest shortfalls on the senior and subordinated certificates is certificated as a “CE” or “X” bond.

result in excess cashflow. The interest portion of excess cashflow is called “excess interest,” and it results partly from interest accruing on the OC amount and partly from the mortgage loans accruing interest on a higher rate than the certificates. In a typical deal, there are three “waterfalls” out of which payments are made to the certificates. The interest payments to certificates are paid from interest received on the mortgage loans (the “interest remittance amount”) in accordance with the interest waterfall and principal payments to certificates are paid from principal received on the mortgage loans (the “principal remittance amount”) in accordance with the principal waterfall. After required interest and principal payments have been paid in their respective waterfalls, the remaining interest and principal remittance amounts are combined to fund the monthly excess cashflow amount, which generally pays (i) any principal not paid by principal remittance in the principal waterfall, (ii) interest and principal shortfalls that were previously incurred by the certificates and (iii) any remaining amounts to the OC certificateholder.

From the beginning of the transaction, accrued interest is paid to both the senior and subordinate certificates.<sup>10</sup> However, principal is solely paid to the senior certificates until a specified date, called the “stepdown date.” The stepdown date represents the date on which the subordinate certificates can first receive principal and it usually refers to the later of a specified date or the date on which the subordination that supports the senior certificates exceeds a specified amount. Excluding the subordinate certificates from receiving principal payments increases the subordination level of the senior certificates because the subordinate certificate balance remains the same (assuming no losses) and the senior certificate balance is reduced. The subordinate certificates are also excluded from principal distributions on any distribution date on which a “trigger event” occurs. Trigger events occur when delinquent loans or losses on loans reach a certain specified level.<sup>11</sup> A recent review of the Intex database indicates that approximately 75% of deals with overcollateralization structures have incurred a trigger event. In addition, all but one deal represented in the ABX index have incurred a trigger event.

For any distribution date before the stepdown date (or for any distribution date on which a trigger event occurs), all principal received on the loans is paid to the senior certificates until the principal balance of each senior class is reduced to zero.<sup>12</sup> For any distribution date on or after the stepdown date (when there is no trigger event), the distribution of payments changes in two ways: (i) the subordinate certificates will be entitled to distributions of principal and (ii) distributions on all classes of certificates will be subject to specified “principal distribution amounts.” These principal distribution amounts ultimately represent the amount that each class

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<sup>10</sup> Interest is paid to the certificates after the servicing fee is paid to the servicer.

<sup>11</sup> Forborne principal may also affect whether a trigger event occurs. If the principal forbearance is applied as a realized loss at the time of the modification, then it may also be counted as a realized loss for purposes of the loss component of the trigger event. If it were so counted, the principal forbearance could cause the cumulative amount of losses realized on the loans in the transaction to exceed the specified level of losses in the definition of trigger event.

<sup>12</sup> In a small number of transactions, if the OC amount exceeds the “target” OC amount, this excess principal amount is permitted to skip the principal waterfall and be paid through the excess cashflow waterfall on distribution dates prior to the stepdown date (or when a trigger event is in effect). If a principal forbearance was not treated as a realized loss, the OC amount would be larger for purposes of this calculation.

must be paid to reduce its principal balance to a specified amount, which is usually calculated as a percentage of the aggregate mortgage loan balance. These specified amounts are determined at the time the deal was structured and ensure that certain levels of subordination are met for each class. They are also one of the factors that rating agencies consider when rating the certificates.

In OC structures, realized losses on the mortgage loans are absorbed first by excess interest and the OC amount and then are applied as realized losses to the certificates if the aggregate certificate principal balance is greater than the mortgage pool balance. Whether forbore principal is treated as a realized loss affects how principal payments are allocated on distribution dates after the stepdown date (when there is no trigger event<sup>13</sup>). In a typical deal, the senior classes of certificates will be paid first up to their senior principal distribution amount and then each subordinate class of certificates will be paid up to its specified principal distribution amount. If we assume that the principal forbearance is not allocated as a realized loss at the time of the modification, principal payments will be affected in two ways. First, because the mortgage pool balance will not be reduced, each principal distribution amount will be less than if a loss were allocated. This is because less cash would be required to pay each class down to its required balance<sup>14</sup> because its required balance would be greater than if a loss were taken. In other words, if a realized loss is allocated to the mortgage pool balance, more principal will be paid to each class, with the more senior classes receiving a higher percentage. The second effect involves situations where no OC amount exists and realized losses on the loans begin to be applied to the subordinate certificates. If the forbearance is not allocated as a realized loss, the subordinate principal distribution amount of the most subordinate class outstanding will be greater than if a loss were allocated. This is because more cash would be required to pay that subordinate class down to its required balance because its beginning balance was greater than if a loss were taken.

Forborne principal also affects how interest payments are allocated within the structure if no OC amount exists. If we assume that the principal forbearance is not applied as a realized loss at the time of the modification, then all of the senior and subordinate classes of certificates would accrue interest on their principal balances for that distribution date. Because the forbore principal does not accrue any interest, what happens next depends on the amount of excess interest. If the excess interest is sufficient to cover the interest not accruing on the amount forbore, there will be sufficient cash to pay each class its accrued interest. If the excess interest is not sufficient, the most subordinate class outstanding will incur an interest shortfall which may or may not be paid on a later date depending on the availability of future excess interest and OC. On each ensuing distribution date where no OC amount exists, the same problem will occur until the forbore amount is either paid or realized as a loss. The interest that does not accrue on the forbore amount must be replaced by excess interest in order for an interest shortfall to not occur. Furthermore, if excess interest is used to pay the certificates so that an interest shortfall

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<sup>13</sup> As noted above, many deals have incurred trigger events so this provision would not apply in those cases.

<sup>14</sup> Note that paying a class “up to its principal distribution amount” or “down to its required balance” effectively means the same thing.

does not occur, there will be less excess interest available to pay principal to the certificates.<sup>15</sup> If a loss were taken at the time of the modification, this interest shortfall would not occur irrespective of the available excess interest amount because the principal balance of the most subordinate class outstanding would be reduced by the forbore amount and interest would no longer accrue on the amount written down.

#### *How to Treat Forborne Principal That is Paid*

The next issue involves accounting for the forbore amount if it is paid by the borrower. This issue affects both types of structures and there are different definitions in the industry relating to this type of payment. If the forbore amount is treated as a realized loss at the time of the modification, the cash received would most likely be considered a “recovery.” Although definitions vary, a recovery is a fairly universal concept that generally refers to an amount received in respect of principal which has previously been allocated as a realized loss. Allocation of a recovery generally involves increasing the balance of the most subordinate class outstanding and treating the recovery as an unscheduled payment that flows through the waterfall in accordance with priorities set forth in the particular deal.

If the forbore amount is not treated as a realized loss at the time of modification, how the applicable party (ie. servicer, master servicer, trustee or bond administrator) would treat the ensuing payment would depend on the type of structure, the particular language of the PSA and the timing of the payment. For example, in shifting interest deals, if the forbore amount was received on the date it was due (ie. the final maturity date of the loan which is potentially 30+ years in the future), the applicable party may decide to treat it as a scheduled payment and the forbore amount would flow through the waterfall as described above. If the forbore amount was received prior to the date it was due, the applicable party may decide to treat it as an unscheduled payment. If it was treated as an unscheduled payment, the forbore amount would be allocated according to the particular percentages for unscheduled payments set forth in the particular deal. In OC deals, no distinction is made between scheduled and unscheduled payments, so the payment would flow through the waterfall as described above.

#### *Effects on Interest Rate Caps*

Subprime transactions and ARM prime transactions generally limit the amount of interest that accrues on the certificates to the net mortgage interest rates of the loans.<sup>16</sup> Interest rate caps are

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<sup>15</sup> As noted above, excess interest is distributed as part of the principal waterfall. For distributions prior to the stepdown date (or on which a trigger event occurs), all excess interest is paid to the senior certificates as principal until they are reduced to zero and then to the subordinate certificates as principal until they are reduced to zero. For distributions on or after the stepdown date (on which no trigger event occurs), excess interest is paid as part of the specified principal distribution amounts to the extent that the principal remittance amount is inadequate. Any remaining excess interest is used to fund the monthly excess cashflow waterfall.

<sup>16</sup> This is achieved in ARM prime deals by setting the pass-through rate at the interest rate cap and in subprime deals by limiting the interest accrual amount to the interest rate cap (pass-through rates in subprime deals are generally greater than the interest rate cap and carryover amounts are paid in the excess cashflow waterfall).

designed to limit the interest accrued on the certificates by imposing an interest rate that the loans can support. An interest rate cap is calculated by weighting the net mortgage interest rates of the loans based upon their principal balances. The effect of forbore principal on interest rate caps depends on whether the forbore amount is included or excluded when weighting the interest rates. For example, let's assume there is a \$2,000 certificate backed by a pool consisting of two loans, each with a \$1,000 balance and with interest rates of 4.00% and 6.00%, respectively. If the 6.00% loan is modified and \$100 is forbore, then only \$900 of that loan is still accruing interest. If the principal balance of the 6.00% loan is calculated as \$1,000, then the loan will be weighted for interest rate cap purposes based on a \$1,000 balance and the interest rate cap for the pool would be 5.00%. If the principal balance of the 6.00% loan is calculated as \$900, then the loan will be weighted for interest rate cap purposes based on a \$900 balance and the interest rate cap for the pool would be 4.95%. It is important to note that neither of these two scenarios would fix the interest rate disparities that are caused by forbore principal (as previously described). Those disparities would still exist because the certificates would accrue interest on a balance that is greater than the balance of the loans. For example, a \$2,000 certificate accruing interest at an interest rate cap of 5.00% would be owed \$100.00 in interest and the same certificate accruing interest at an interest rate cap of 4.95% would be owed \$99.00 in interest (in both cases, assuming one annual payment). In this example, the \$900 is accruing interest at 6.00% and the \$1,000 is accruing interest at 4.00%, which only produces \$94.00 and results in a shortfall in both cases.

The above example portrays a situation where the interest rate cap is reduced because the higher interest rate of the two loans has been given less "weight" in the calculation. The opposite would occur (ie. the interest rate cap would increase) if the loan with the lower of the two rates was weighted on a smaller balance. This scenario would be more applicable to loans that have been modified under the HAMP program, as the interest rate would be reduced to 2.00% before principal could be forbore.

#### *Effects on Servicing and Master Servicing*

As noted above, PSAs typically do not set forth explicit guidance for servicers and master servicers of loans that have forbore principal. Furthermore, it does not appear that the servicer safe harbor contained in the Helping Families Save Their Homes Act will provide any relief for this issue. This legislation provides a safe harbor for modifications performed by a servicer pursuant to the HAMP program but it appears not to have an effect on the servicer, master servicer, trustee or bond administrator who must ultimately decide how to allocate a principal forbearance in a securitization.

Forbore principal may also affect the fee collected by servicers to service the mortgage loans. Servicing fees are paid on each distribution date based on the scheduled principal balance of each mortgage loan serviced by the servicer. Most deals allow servicing fees to be collected out of interest payments on the mortgage loans, prior to any payments to the certificates. Some issuers specify that the servicing fee for each mortgage loan can only be paid from the interest portion of the monthly payment or other payment of interest received on the mortgage loan. In most cases, these provisions do not specifically preclude a servicer from recovering the portion of the servicing fee relating to the forbore principal (unless the definition of scheduled principal balance is read to be reduced by the amount forbore), and there will generally be enough

interest accrued on the loan (even with non-interest bearing forborne principal) to pay the servicing fee on the entire principal balance. However, there are some agreements that require the servicing fee to be collected on the same principal amount on which interest on the loan accrues. If the forborne principal is treated as a realized loss at the time of the modification, servicers will not be able to collect the servicing fee relating to the forborne principal.

### **III. Views of Market Participants**

The discussion below is included to provide a broader understanding of the views currently held by market participants. These views are specific to each particular group and do not represent the views of the ASF or the industry as a whole.

#### *Senior Certificateholders*

Senior holders believe that forborne principal should be allocated as a realized loss at the time of the modification. Their view stems partly from the fact that, because forborne principal does not accrue interest and is not scheduled to be repaid until the loan's maturity date, its net economic value to the trust is extremely low, similar to principal forgiveness. The interest cash flows on the forborne principal have been liquidated permanently, and the principal balance has been converted from an amortizing payment stream to an uncertain potential recovery at the maturity of the loan. If the forborne principal is not treated as a realized loss at the time of the modification, the certificates will effectively become under-collateralized as this forborne principal is not able to support the expected payments on the certificates. Coupon-bearing liabilities will be collateralized by non-coupon-bearing assets, and this problem becomes exacerbated over time as the amortizing portion of the loans pay down, leaving the remaining certificates collateralized by an increasing percentage of forborne principal over time. If the forborne principal is not recognized as an immediate loss, senior certificates will be shorted increasing amounts of cash while junior certificates are steadily paid down. Furthermore, senior holders note that the PSAs never envisioned the concept of principal forbearance and therefore are silent on the impact of forbearance on trust liabilities. PSAs do not contemplate modifications conforming to the Treasury Guidelines, and therefore the definition of "Realized Loss" is silent as to such modifications. Noting that the primary rule of contract construction is to effectuate the intent of the parties, senior holders note that this treatment undermines the senior-subordinate structure on which many investors relied in making their investment decisions. Senior holders note that New York law, which typically governs the PSAs, imposes a duty of good faith and fair dealing upon contracting parties, which prohibits depriving a party of the benefits of the contract. Given that certain PSAs do not address the allocation of losses due to modifications (and in many cases do not even address modifications), a condition is implied that the contract should be administered in a manner that is consistent with the expected order of payment and that ensures that the trust's assets are able to support its liabilities. Stated another way, there is an implied duty to administer the trust in a manner that does not create a fiction with respect to the assets and liabilities of the trust. If principal forbearance amounts are not characterized as realized losses, then that would breach the implied duty of good faith and fair dealing by distributing funds to subordinate holders that will create an imbalance between the trust's liabilities and assets, which will become progressively worse over time and will likely result in the trust becoming effectively insolvent. It is not good faith and fair dealing to pay out

funds based on a distribution schedule that is predicated on an assumption that the assets will support the liabilities, when in fact all parties to the securitization know that is not the case.

As further support for their position, senior holders note that the FDIC's Loan Modification Program for IndyMac specifically states, "[f]or loans within securitizations, this principal forbearance should be passed as a write-off of principal to the trust, with any future collections at time of pay-off submitted to the trust as a recovery."<sup>17</sup> The FDIC reviewed hundreds of PSAs in reaching this conclusion. Senior holders also note that over 90% of current RMBS certificateholders are senior holders, meaning that over 90% of the market would benefit from forbore principal being immediately allocated as a realized loss.

Senior holders believe that the forbore principal of a mortgage loan should be treated as a partial liquidation of such loan. As noted above, "realized loss" is generally defined by reference to a "liquidated mortgage loan" (see Appendix I for examples). Senior holders believe the definition of "liquidated mortgage loan" is open to interpretation because the terms "liquidate," "liquidated" and "liquidation," which are used in the definition, are generally not defined in the PSAs. As such, senior holders believe that the realized loss definitions contained in PSAs should be construed to include forbore principal. Senior holders believe that this approach is consistent with the purpose underlying the concept of subordination in securitization (i.e. that losses are allocated from the bottom up to protect senior holders). Senior holders point to several of the definitions of "liquidate," "liquidated" and "liquidation" contained in Black's Law Dictionary to support their reading of these terms in PSAs, including: "[t]o settle (an obligation) by payment or other adjustment; to extinguish (a debt)," "[t]o ascertain the precise amount of (debt, damages, etc.) by litigation or agreement," "to adjust or settle a debt," "[o]f an amount or debt) settled or determined, esp. by agreement" and "the act or process of settling or making clear, fixed, and determinate that which before was uncertain or unascertained." They believe the interest cashflows on the forbore amount have been liquidated and that therefore the forbearance is a partial liquidation. In addition, senior holders note that the arguments based on a restrictive definition of realized loss ignores the reason why the term realized loss is used in the PSAs. The allocation of realized losses to reduce the balances of subordinate securities is a necessary component of the capital structure of securitizations and is a feature that has been required by investors and by rating agencies for thousands of securitizations to keep the assets and liabilities of the trusts in balance. To focus on only those specific events included in the definition of realized loss to the exclusion of economically equivalent events ignores the intent of the parties in requiring the allocation of realized losses. Moreover, the fact that the rating agencies would downgrade senior certificates if principal forbearance amounts are not treated as realized losses at the time of the modification is further evidence that any other approach ignores the intent and expectations of parties to the securitization.

In the case of shifting interest transactions containing provisions (see Appendix II for examples) that further adjust the aggregate certificate principal balance to equal the aggregate "stated" or "scheduled" principal balance of the loans, senior holders believe that the definition of "stated principal balance" (or "scheduled principal balance") of a loan should be read to decrease such

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<sup>17</sup> See <http://www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf>

amount by the forbore principal. Examples of stated principal balance (or scheduled principal balance) definitions contained in several publicly filed PSAs are included in Appendix I.

Senior holders also believe that principal forbearance must be treated as an immediate realized loss to maintain equitable treatment of a modification. Modifications are performed on loans that are either in default or in imminent risk of default. If these loans were to be liquidated, the subordinate certificates would take an immediate loss. Loan modifications are applied only in a positive net present value (“NPV”) scenario, where the NPV of the modified loan is greater than the expected recovery through foreclosure and liquidation. Recognizing the forbore principal as an immediate loss represents a better scenario for subordinate certificates relative to the foreclosure/liquidation process because the upfront loss should be less than the expected liquidation loss, and there still remains the possibility for an additional recovery of the forbore principal. Essentially, both senior and subordinate certificateholders benefit through principal forbearance modifications where the forbearance is recognized as an immediate loss. If principal forbearance is not recognized as an immediate loss, the subordinate certificates will receive a substantial and unintended windfall, as no loss is recognized and the subordinate certificates will continue to receive payments despite the impairment to the collateral, while the senior holders will experience a worse outcome than they would have otherwise received if the loan were liquidated. It is entirely inequitable for a modified loan to be treated such that it creates a windfall for one investor class at the expense of another class, when it should be treated in a manner that benefits all classes.

#### *Subordinate Certificateholders*

Subordinate holders believe that, because forbore principal is still owed by the borrower, a loss should not be taken until the loan is actually liquidated. As noted above, if forbore principal is immediately allocated as a realized loss, the most subordinate class outstanding would generally be reduced accordingly and it would no longer be entitled to interest on the amount written down. Furthermore, if the borrower later pays the amount forbore, the subordinate class that initially bore the realized loss may no longer be outstanding and may not benefit from either the recovery flowing through the waterfall or the increase in a class’ principal balance resulting from the recovery.

Subordinate holders believe that the realized loss definitions contained in PSAs cannot be construed to include forbore principal. Subordinate holders do not believe principal forbearance is akin to liquidation and point to the definitions of “liquidated mortgage loan” in Appendix I which generally state that the servicer must make a determination that it has received all amounts it expects to receive in connection with the liquidation of the mortgage loan. In the case of shifting interest transactions containing provisions (see Appendix II for examples) that further adjust the aggregate certificate principal balance to equal the aggregate “stated” or “scheduled” principal balance of the loans, subordinate holders believe that the definition of “stated principal balance” (or “scheduled principal balance”) of a loan should not be read to decrease such amount by the principal forbore. Subordinate holders point to the definitions of “stated principal balance” in Appendix I which reference the balance specified in the amortization schedule “before any adjustment to such amortization schedule by reason of any moratorium or similar waiver or grace period.” Subordinate holders believe a principal forbearance would be excluded under that provision.

### *Senior and Subordinate Certificateholders*

Senior and subordinate holders are concerned about the cashflow implications of servicers collecting servicing fees on forbore principal. For example, if the servicer is following the HAMP program and has reached the principal forbearance step of the modification protocol, then the servicer has already reduced the interest rate on the mortgage loan to 2.00%. As most servicing fees range from 25 to 50 basis points, the servicer will be collecting between 12.5% and 25% of the interest collections on the mortgage loan as servicing compensation. That in and of itself would be a substantial share of the interest collections on the loan. If the servicer continued to collect the servicing fee on the forbore principal, then the servicer's compensation as a percentage of the interest collections on the loan would be even greater.

### *Master Servicers*

Master servicers have expressed differing views on this issue depending on the substance of the underlying PSA. From a liability standpoint, some master servicers believe that forbore principal should not be allocated as a realized loss because the realized loss definitions contained in PSAs do not specifically include forbore principal. Master servicers also have expressed concern over the inconsistency of language from program to program. They believe it will be very difficult to implement a general standard when each deal has different terms. From an operations standpoint, master servicers believe that treating forbore principal as an immediate realized loss is the better option because accounting for forbore principal can be very complicated and difficult to administer. However, master servicers are concerned that treating a forbearance as a realized loss will set a poor precedent because a potentially unwarranted assumption regarding a borrower's ability to pay must be made immediately after a loan is modified.

### *Trustees and Other Bond Administrators*

Trustees believe that, under the PSA, it is the servicer's or master servicer's responsibility to determine whether to allocate forbore principal as an immediate realized loss. Trustees note that it is extremely important for RMBS transactions that servicers keep accurate records of the new scheduled principal balance and the amount forbore.

### *Primary Servicers*

Servicers believe that master servicers or trustees should decide whether to allocate forbore principal as a realized loss at the time of the modification. Servicers indicate that at least one master servicer has agreed with this position. Servicers acknowledge that in a full liquidation, they would be responsible for determining which amounts will be recoverable and which amounts will be realized as a loss. However, servicers argue that their role is different when principal is forbore because the borrower still owes the amount and servicers are unable to determine whether it will actually be paid.

When principal is forbore, servicers report two amounts to the master servicer (or trustee): (i) a reduced scheduled principal balance upon which monthly principal and interest payments are calculated (and upon which the servicers will still advance) and (ii) a forbore amount that does not accrue interest (and upon which the servicers will no longer advance). Servicers report

forborne amounts as receivables or as a form of deferred principal. All servicers agree that if a forborne amount was immediately allocated as a realized loss, any ensuing payment received on the forborne amount would be a recovery because the amount received would not be a part of the unpaid scheduled principal balance of the loan. Many servicers are not collecting servicing fees on amounts forborne because interest is not accruing on those amounts, but other servicers have yet to make a determination on that issue.

### *Financial Guarantors*

Financial guarantors guarantee both first- and second-lien transactions as well as CDOs with underlying first-lien collateral. They have exposure to senior as well as subordinate tranches in RMBS transactions. Allocating forborne principal as a realized loss could have varying effects on different portions of the financial guarantors' portfolios. In the case of shifting interest first-lien wrapped prime/Alt-A transactions, the financial guarantors would see their exposures reduced more quickly. However, for second-lien transactions where financial guarantors usually need to make parity payments, allocating forbearance as a realized loss at the time of modification will directly lead to claims payments.

Given this all-round exposure, financial guarantors strongly believe in adherence to the legal documents, such as the PSAs and to the generally accepted definition of forbearance. Traditionally within securitizations, forbearance is viewed as a temporary respite to the borrower, whereby the borrower's obligation is transferred from the present to a future date. Forbearance, typically, does not mean that the debt is forgiven, but that the payments may be reduced and/or delayed for a period of time. Hence it is a clear contravention of the forbearance definition to treat it as a write-down or a loss because forbearance is not forgiveness. Financial guarantors assert that they wrapped the bonds – senior and subordinate - relying on the legal documents, such as the PSAs and the traditional interpretations of the terms within such documents and they may have to make additional claims payments if these documents are modified to favor certain other parties involved in the transactions.

Finally, financial guarantors note that most OC structures have incurred a trigger event and the current levels of delinquencies and cumulative losses would preclude any principal payments to the subordinate certificates until all the senior certificates are completely paid off.

### *Other Market Views*

An alternative approach was raised for calculating interest rate caps that would resolve for subprime and ARM prime deals the interest disparities caused by forborne principal. Let's once again assume there is a \$2,000 certificate backed by a pool consisting of two loans, each with a \$1,000 balance and with interest rates of 4.00% and 6.00%, respectively. If the 6.00% loan is modified and \$100 is forborne, then only \$900 of that loan is still accruing interest. If the portion accruing interest and the forborne amount are treated as separate pieces, we have a \$900 piece accruing interest at 6.00% and a \$100 piece at 0.00%. This effectively creates one \$1,000 loan that accrues interest at 5.40% on a \$1,000 balance, resulting in an interest rate cap for the pool of 4.70%. The \$2,000 certificate accruing interest at the interest rate cap of 4.70% would be owed \$94.00 in interest (assuming one annual payment). In this example, the \$900 is accruing interest at 6.00% and the \$1,000 is accruing interest at 4.00%, which produces the

required \$94.00 to pay the certificate. It is important to note that the more senior holders would not support this approach because it would lower their interest accrual amounts so that all classes could be paid.

#### **IV. Conclusion**

The principal forbearance issues outlined in this piece are critical for many of our issuer, servicer, trustee and investor members. We hope this piece helps illuminate the trust accounting challenges that are created when principal is forborne under a modification program such as the HAMP.

If you have any questions or concerns related to principal forbearance or to this discussion paper, please do not hesitate to contact either Tom Deutsch, ASF Deputy Executive Director, at [tdeutsch@americansecuritization.com](mailto:tdeutsch@americansecuritization.com) or 212.313.1135 or our counsel on this project, Evan Siegert, Cadwalader, Wickersham and Taft LLP, at [evan.siegert@cwt.com](mailto:evan.siegert@cwt.com) or 212.313.1178.

## APPENDIX I

Listed below is a random sampling of PSA definitions relating to the above discussion for both shifting interest and overcollateralization transactions. These definitions were taken from publicly filed transactions and are listed in alphabetical order based upon the name of the transaction's sponsor. This list has been assembled to provide examples of certain definitions found in RMBS transactions and it is not meant to include all possible iterations of these terms. While these definitions have been provided to assist in the reader's understanding of the issues outlined in this paper, it is recommended that each applicable PSA be reviewed in order to obtain a complete picture of the transaction.

### **Shifting Interest Transactions**

**Sponsor: Bank of America, National Association**

**Issuing Entity: Banc of America Mortgage 2007-4 Trust**

Realized Loss: With respect to each Liquidated Mortgage Loan, an amount as of the date of such liquidation, equal to (i) the unpaid principal balance of the Liquidated Mortgage Loan as of the date of such liquidation, plus (ii) interest at the Net Mortgage Interest Rate from the Due Date as to which interest was last paid or advanced (and not reimbursed) to Certificateholders up to the Due Date in the month in which Liquidation Proceeds are required to be distributed on the Stated Principal Balance of such Liquidated Mortgage Loan from time to time, minus (iii) the Liquidation Proceeds, if any, received during the month in which such liquidation occurred, to the extent applied as recoveries of interest at the Net Mortgage Interest Rate and to principal of the Liquidated Mortgage Loan. With respect to each Mortgage Loan that has become the subject of a Deficient Valuation, if the principal amount due under the related Mortgage Note has been reduced, the difference between the principal balance of the Mortgage Loan outstanding immediately prior to such Deficient Valuation and the principal balance of the Mortgage Loan as reduced by the Deficient Valuation. With respect to any Distribution Date and each Mortgage Loan that (i) has become the subject of a Debt Service Reduction, the amount, if any, by which the principal portion of the related Monthly Payment has been reduced or (ii) has become the subject of a Servicer Modification, any permanent reduction in the principal balance thereof resulting from such Servicer Modification.

Liquidated Mortgage Loan: With respect to any Distribution Date, a defaulted Mortgage Loan (including any REO Property) that was liquidated in the calendar month preceding the month of such Distribution Date and as to which the Servicer has certified (in accordance with this Agreement) that it has received all proceeds it expects to receive in connection with the liquidation of such Mortgage Loan including the final disposition of an REO Property.

Stated Principal Balance: As to any Mortgage Loan and date, the unpaid principal balance of such Mortgage Loan as of the specified Due Date or, if not specified, as of the Due Date immediately preceding such date as specified in the amortization schedule at the time relating thereto (before any adjustment to such amortization schedule by reason of any moratorium or

similar waiver or grace period or any adjustment to such amortization schedule for any Capitalized Advance Amounts other than the amount of such Capitalized Advance Amounts which have been reimbursed to the applicable Servicer from payments on Mortgage Loans other than the Mortgage Loans with respect to which such Capitalized Advance Amounts relate) after giving effect to (A) any previous partial Principal Prepayments and Liquidation Proceeds allocable to principal (other than with respect to any Liquidated Mortgage Loan) and, (B) to the payment of principal due on such Due Date and irrespective of any delinquency in payment by the related Mortgagor, (C) any Deficient Valuation and (D) any Realized Losses as a result of Servicer Modifications incurred prior to such Due Date.

**Sponsor: Chase Home Finance LLC**

**Issuing Entity: Chase Mortgage Finance Trust Series 2006-S4**

REALIZED LOSS: With respect to (i) a Liquidated Mortgage Loan, the amount, if any, by which the unpaid Principal Balance and accrued interest thereon at a rate equal to the Net Mortgage Rate exceeds the amount actually recovered by the Servicer with respect thereto (net of reimbursement of Advances and Servicing Advances) at the time such Mortgage Loan became a Liquidated Mortgage Loan or (ii) with respect to a Mortgage Loan which is not a Liquidated Mortgage Loan, any amount of principal that the Mortgagor is no longer legally required to pay (except for the extinguishment of debt that results from the exercise of remedies due to default by the Mortgagor).

LIQUIDATED MORTGAGE LOAN: Any Mortgage Loan (a) as to which the Servicer has determined that all amounts which it expects to recover from or on account of such Mortgage Loan or property acquired in respect thereof have been recovered, (b) as to which a Cash Liquidation has taken place or (c) with respect to which the Mortgaged Property (or stock allocated to a dwelling unit, in the case of a Co-op Loan) has been acquired by foreclosure or deed in lieu of foreclosure and a disposition (the term disposition shall include, for purposes of a repurchase pursuant to Section 11.01, any repurchase of a Mortgaged Property (or stock allocated to a dwelling unit, in the case of a Co-op Loan) pursuant to such Section) of such Mortgaged Property (or stock allocated to a dwelling unit, in the case of a Co-op Loan) has occurred.

SCHEDULED PRINCIPAL BALANCE: With respect to any Mortgage Loan as of any Distribution Date, the unpaid principal balance of such Mortgage Loan as specified in the amortization schedule at the time relating thereto (before any adjustment to such schedule by reason of bankruptcy or similar proceeding or any moratorium or similar waiver or grace period) as of the Due Date in the month preceding the month of such Distribution Date, or as the Cut-off Date, with respect to the first (1st) Distribution Date, after giving effect to any previously applied prepayments, the payment of principal due on such first day of the month and any reduction of the principal balance of such Mortgage Loan by a bankruptcy court, irrespective of any delinquency in payment by the related Mortgagor.

**Sponsor: CitiMortgage, Inc.**

**Issuing Entity: Citicorp Mortgage Securities Trust, Series 2007-5**

realized losses: For a distribution day, liquidated loan losses (including special hazard losses and fraud losses) and bankruptcy losses incurred in the preceding month. For a realized loss consisting of a liquidated loan loss, the interest and principal portions of the realized loss will equal the interest and principal portions of the liquidated loan loss.

liquidated loan loss: For a distribution day, the aggregate losses for each mortgage loan that became a liquidated loan prior to the first day of the month that contains the distribution day, which for each such liquidated loan will equal the excess of (A) the unpaid principal balance of the mortgage loan on the first day of the preceding month, plus (B) accrued interest in accordance with the amortization schedule at the time applicable to the mortgage loan at the applicable mortgage note rate from the first day of the month as to which interest was last paid on the mortgage loan through the last day of the month in which the mortgage loan became a liquidated loan, over the net liquidation proceeds for the mortgage loan.

liquidated loan: A mortgage loan for which the related mortgaged property has been acquired, liquidated or foreclosed, and the relevant servicer determines that all liquidation proceeds it expects to recover have been recovered, or the related mortgaged property is retained or sold by the mortgagor, and the relevant servicer has accepted payment from the mortgagor in consideration for the release of the mortgage in an amount that is less than the outstanding principal balance of the mortgage loan as a result of a determination by the relevant servicer that the potential liquidation expenses for the mortgage loan would exceed the amount by which the cash portion of such payment is less than the outstanding principal balance of the mortgage loan.

scheduled principal balance: For one or more mortgage loans on a date, the initial principal balance of the loans, less the sum of (a) the aggregate of the principal portion of all scheduled monthly loan payments required to be made on the loans on or before the first day of the month in which the date falls (whether or not received), provided that after the bankruptcy coverage termination date, the scheduled principal balance will not be reduced by the principal portion of any debt service reductions, and (b) any principal prepayments on the loans received or posted before the close of business on the last business day of the preceding month.

**Sponsor: Countrywide Home Loans**

**Issuing Entity: CHL Mortgage Pass-Through Trust 2007-11**

Realized Loss: With respect to each Liquidated Mortgage Loan, an amount (not less than zero or more than the Stated Principal Balance of the Mortgage Loan) as of the date of such liquidation, equal to (i) the Stated Principal Balance of the Liquidated Mortgage Loan as of the date of such liquidation, plus (ii) interest at the Adjusted Net Mortgage Rate from the Due Date as to which interest was last paid or advanced (and not reimbursed) to Certificateholders up to the Due Date in the month in which Liquidation Proceeds are

required to be distributed on the Stated Principal Balance of such Liquidated Mortgage Loan from time to time, minus (iii) the Liquidation Proceeds, if any, received during the month in which such liquidation occurred, to the extent applied as recoveries of interest at the Adjusted Net Mortgage Rate and to principal of the Liquidated Mortgage Loan. With respect to each Mortgage Loan which has become the subject of a Deficient Valuation, if the principal amount due under the related Mortgage Note has been reduced, the difference between the principal balance of the Mortgage Loan outstanding immediately prior to such Deficient Valuation and the principal balance of the Mortgage Loan as reduced by the Deficient Valuation.

To the extent the Master Servicer receives Subsequent Recoveries with respect to any Liquidated Mortgage Loan, the amount of the Realized Loss with respect to that Mortgage Loan will be reduced by such Subsequent Recoveries.

Liquidated Mortgage Loan: With respect to any Distribution Date, a defaulted Mortgage Loan (including any REO Property) which was liquidated in the calendar month preceding the month of such Distribution Date and as to which the Master Servicer has determined (in accordance with this Agreement) that it has received all amounts it expects to receive in connection with the liquidation of such Mortgage Loan, including the final disposition of an REO Property.

Stated Principal Balance: As to any Mortgage Loan and Due Date, the unpaid principal balance of such Mortgage Loan as of such Due Date, as specified in the amortization schedule at the time relating thereto (before any adjustment to such amortization schedule by reason of any moratorium or similar waiver or grace period) minus the sum of: (i) any previous partial Principal Prepayments and the payment of principal due on such Due Date, irrespective of any delinquency in payment by the related Mortgagor, (ii) Liquidation Proceeds allocable to principal (other than with respect to any Liquidated Mortgage Loan) received in the prior calendar month and Principal Prepayments received through the last day of the related Prepayment Period, in each case with respect to that Mortgage Loan and (iii) any Realized Loss previously incurred in connection with a Deficient Valuation. The Stated Principal Balance of any Mortgage Loan that becomes a Liquidated Mortgage Loan will be zero on each date following the Due Period in which such Mortgage Loan becomes a Liquidated Mortgage Loan.

**Sponsor: IndyMac Bank, F.S.B.**

**Issuing Entity: IndyMac IMJA Mortgage Loan Trust 2007-A3**

Realized Loss: With respect to each Liquidated Mortgage Loan, an amount (not less than zero or more than the Stated Principal Balance of the Mortgage Loan) as of the date of such liquidation, equal to (i) the Stated Principal Balance of the Liquidated Mortgage Loan as of the date of such liquidation, plus (ii) interest at the Adjusted Net Mortgage Rate from the Due Date as to which interest was last paid or advanced (and not reimbursed) to Certificateholders up to the Due Date in the month in which Liquidation Proceeds are required to be distributed on the Stated Principal Balance of such Liquidated Mortgage Loan

from time to time, minus (iii) the Liquidation Proceeds, if any, received during the month in which such liquidation occurred, to the extent applied as recoveries of interest at the Adjusted Net Mortgage Rate and to principal of the Liquidated Mortgage Loan. With respect to each Mortgage Loan that has become the subject of a Deficient Valuation, if the principal amount due under the related Mortgage Note has been reduced, the difference between the principal balance of the Mortgage Loan outstanding immediately prior to such Deficient Valuation and the principal balance of the Mortgage Loan as reduced by the Deficient Valuation. With respect to each Mortgage Loan that has become the subject of a Debt Service Reduction and any Distribution Date, the amount, if any, by which the principal portion of the related Scheduled Payment has been reduced.

To the extent the Servicer receives Subsequent Recoveries with respect to any Mortgage Loan, the amount of the Realized Loss with respect to that Mortgage Loan will be reduced by such Subsequent Recoveries.

Liquidated Mortgage Loan: For any Distribution Date, a defaulted Mortgage Loan (including any REO Property) that was liquidated in the calendar month preceding the month of the Distribution Date and as to which the Servicer has certified (in accordance with this Agreement) that it has received all amounts it expects to receive in connection with the liquidation of the Mortgage Loan, including the final disposition of an REO Property.

Stated Principal Balance: As to any Mortgage Loan and Due Date, the unpaid principal balance of such Mortgage Loan as of such Due Date, as specified in the amortization schedule at the time relating thereto (before any adjustment to such amortization schedule by reason of any moratorium or similar waiver or grace period) after giving effect to the sum of: (i) the payment of principal due on such Due Date and irrespective of any delinquency in payment by the related Mortgagor and (ii) any Liquidation Proceeds allocable to principal received in the prior calendar month and Principal Prepayments received through the last day of the Prepayment Period in which the Due Date occurs, in each case with respect to such Mortgage Loan.

**Sponsor: Residential Funding Corporation**  
**Issuing Entity: RFMSI Series 2006-S4 Trust**

Realized Loss: With respect to each Mortgage Loan (or REO Property): (a)...as to which a Cash Liquidation or REO Disposition has occurred, an amount (not less than zero) equal to (i) the Stated Principal Balance of the Mortgage Loan (or REO Property) as of the date of Cash Liquidation or REO Disposition, plus (ii) interest (and REO Imputed Interest, if any) at the Net Mortgage Rate from the Due Date as to which interest was last paid or advanced to Certificateholders up to the Due Date in the Due Period related to the Distribution Date on which such Realized Loss will be allocated pursuant to Section 4.05 on the Stated Principal Balance of such Mortgage Loan (or REO Property) outstanding during each Due Period that such interest was not paid or advanced, minus (iii) the proceeds, if any, received during the month in which such Cash Liquidation (or REO Disposition) occurred, to the extent applied as recoveries of interest at the Net Mortgage

Rate and to principal of the Mortgage Loan, net of the portion thereof reimbursable to the Master Servicer or any Subservicer with respect to related Advances, Servicing Advances or other expenses as to which the Master Servicer or Subservicer is entitled to reimbursement thereunder but which have not been previously reimbursed, (b)....which is the subject of a Servicing Modification, (i) (1) the amount by which the interest portion of a Monthly Payment or the principal balance of such Mortgage Loan was reduced or (2) the sum of any other amounts owing under the Mortgage Loan that were forgiven and that constitute Servicing Advances that are reimbursable to the Master Servicer or a Subservicer, and (ii) any such amount with respect to a Monthly Payment that was or would have been due in the month immediately following the month in which a Principal Prepayment or the Purchase Price of such Mortgage Loan is received or is deemed to have been received, (c)....which has become the subject of a Deficient Valuation, the difference between the principal balance of the Mortgage Loan outstanding immediately prior to such Deficient Valuation and the principal balance of the Mortgage Loan as reduced by the Deficient Valuation, or (d)....which has become the object of a Debt Service Reduction, the amount of such Debt Service Reduction.

Notwithstanding the above, neither a Deficient Valuation nor a Debt Service Reduction shall be deemed a Realized Loss hereunder so long as the Master Servicer has notified the Trustee in writing that the Master Servicer is diligently pursuing any remedies that may exist in connection with the representations and warranties made regarding the related Mortgage Loan and either (A) the related Mortgage Loan is not in default with regard to payments due thereunder or (B) delinquent payments of principal and interest under the related Mortgage Loan and any premiums on any applicable primary hazard insurance policy and any related escrow payments in respect of such Mortgage Loan are being advanced on a current basis by the Master Servicer or a Subservicer, in either case without giving effect to any Debt Service Reduction.

To the extent the Master Servicer receives Subsequent Recoveries with respect to any Mortgage Loan, the amount of the Realized Loss with respect to that Mortgage Loan will be reduced to the extent such recoveries are applied to reduce the Certificate Principal Balance of any Class of Certificates on any Distribution Date.

Cash Liquidation: As to any defaulted Mortgage Loan other than a Mortgage Loan as to which an REO Acquisition occurred, a determination by the Master Servicer that it has received all Insurance Proceeds, Liquidation Proceeds and other payments or cash recoveries which the Master Servicer reasonably and in good faith expects to be finally recoverable with respect to such Mortgage Loan.

Stated Principal Balance: With respect to any Mortgage Loan or related REO Property, at any given time, (i) the sum of (a) the Cut-off Date Principal Balance of the Mortgage Loan plus (b) any amount by which the Stated Principal Balance of the Mortgage Loan is increased pursuant to a Servicing Modification, minus (ii) the sum of (a) the principal portion of the Monthly Payments due with respect to such Mortgage Loan or REO Property during each Due Period ending prior to the most recent Distribution Date which were received or with respect to which an Advance was made, and (b) all Principal Prepayments with respect to such Mortgage Loan or REO Property, and all Insurance Proceeds,

Liquidation Proceeds and REO Proceeds, to the extent applied by the Master Servicer as recoveries of principal in accordance with Section 3.14 with respect to such Mortgage Loan or REO Property, in each case which were distributed pursuant to Section 4.02 on any previous Distribution Date, and (c) any Realized Loss allocated to Certificateholders with respect thereto for any previous Distribution Date.

**Sponsor: Wells Fargo Bank, N.A.**

**Issuing Entity: Wells Fargo Mortgage Backed Securities 2007-11 Trust**

Realized Losses: With respect to any Distribution Date, (i) Liquidated Loan Losses incurred on Liquidated Loans for which the Liquidation Proceeds were received during the Applicable Unscheduled Principal Receipt Period with respect to Full Unscheduled Principal Receipts with respect to such Distribution Date and (ii) Bankruptcy Losses incurred during the period corresponding to the Applicable Unscheduled Principal Receipt Period with respect to Full Unscheduled Principal Receipts for such Distribution Date.

Liquidated Loan: A Mortgage Loan with respect to which the related Mortgaged Property has been acquired, liquidated or foreclosed and with respect to which the applicable Servicer determines that all Liquidation Proceeds which it expects to recover have been recovered.

Liquidated Loan Loss: With respect to any Distribution Date, the aggregate of the amount of losses with respect to each Mortgage Loan which became a Liquidated Loan during the Applicable Unscheduled Principal Receipt Period with respect to Full Unscheduled Principal Receipts for such Distribution Date, equal to the excess of (i) the unpaid principal balance of each such Liquidated Loan, plus accrued interest thereon in accordance with the amortization schedule at the time applicable thereto at the applicable Net Mortgage Interest Rate from the Due Date as to which interest was last paid with respect thereto through the last day of the month preceding the month in which such Distribution Date occurs, over (ii) Net Liquidation Proceeds with respect to such Liquidated Loan.

Scheduled Principal Balance: As to any Mortgage Loan and Distribution Date, the principal balance of such Mortgage Loan as of the Due Date in the month preceding the month of such Distribution Date as specified in the amortization schedule at the time relating thereto (before any adjustment to such amortization schedule by reason of any bankruptcy (other than Deficient Valuations) or similar proceeding or any moratorium or similar waiver or grace period) after giving effect to (A) Unscheduled Principal Receipts received or applied by the applicable Servicer during the related Unscheduled Principal Receipt Period for each applicable type of Unscheduled Principal Receipt related to the Distribution Date occurring in the month preceding such Distribution Date, (B) Deficient Valuations incurred prior to such Due Date and (C) the payment of principal due on such Due Date and irrespective of any delinquency in payment by the related Mortgagor. Accordingly, the Scheduled Principal Balance of a Mortgage Loan which becomes a Liquidated Loan at any time through the last day of such related Unscheduled Principal Receipt Period shall be zero.

## **Overcollateralization Transactions**

**Sponsor: Bank of America, National Association**

**Issuing Entity: ABFC 2006-HE1 Trust**

Realized Loss: With respect to a Liquidated Mortgage Loan, the amount by which the remaining unpaid principal balance of the Mortgage Loan exceeds the amount of Net Liquidation Proceeds applied to the principal balance of the related Mortgage Loan. With respect to any Mortgage Loan, a Deficient Valuation or a reduction in the Principal Balance thereof resulting from a Servicer Modification.

Liquidated Mortgage Loan: As to any Distribution Date, any Mortgage Loan in respect of which the related Servicer has determined, in accordance with the applicable Servicing Standard, as of the end of the related Prepayment Period, that all Liquidation Proceeds, Condemnation Proceeds and Insurance Proceeds which it expects to recover with respect to the liquidation of the Mortgage Loan or disposition of the related REO Property have been recovered.

Principal Balance: As to any Mortgage Loan and any day, other than a Liquidated Mortgage Loan, the related Cut-off Date Principal Balance, minus the sum of (i) all collections and other amounts credited against the principal balance of any such Mortgage Loan, (ii) the principal portion of Advances, (iii) any Deficient Valuation and (iv) any principal reduction resulting from a Servicer Modification. For purposes of this definition, a Liquidated Mortgage Loan shall be deemed to have a Principal Balance equal to the Principal Balance of the related Mortgage Loan as of the final recovery of related Liquidation Proceeds and a Principal Balance of zero thereafter. As to any REO Property and any day, the Principal Balance of the related Mortgage Loan immediately prior to such Mortgage Loan becoming REO Property minus any REO Principal Amortization received with respect thereto on or prior to such day.

**Sponsor: Countrywide Home Loans**

**Issuing Entity: CWABS Asset-Backed Certificates Trust 2007-5**

Realized Loss: With respect to each Liquidated Mortgage Loan, an amount (not less than zero or more than the Stated Principal Balance of the Mortgage Loan) as of the date of such liquidation, equal to (i) the Stated Principal Balance of such Liquidated Mortgage Loan as of the date of such liquidation, minus (ii) the Liquidation Proceeds, if any, received in connection with such liquidation during the month in which such liquidation occurs, to the extent applied as recoveries of principal of the Liquidated Mortgage Loan. With respect to each Mortgage Loan that has become the subject of a Deficient Valuation, (i) if the value of the related Mortgaged Property was reduced below the principal balance of the related Mortgage Note, the amount by which the value of the Mortgaged Property was reduced below the principal balance of the related Mortgage Note, and (ii) if the principal amount due under the related Mortgage Note has been reduced, the difference between the principal

balance of the Mortgage Loan outstanding immediately prior to such Deficient Valuation and the principal balance of the Mortgage Loan as reduced by the Deficient Valuation.

Liquidated Mortgage Loan: With respect to any Distribution Date, a defaulted Mortgage Loan that has been liquidated through deed-in-lieu of foreclosure, foreclosure sale, trustee's sale or other realization as provided by applicable law governing the real property subject to the related Mortgage and any security agreements and as to which the Master Servicer has certified in the related Prepayment Period that it has received all amounts it expects to receive in connection with such liquidation.

**Sponsor: Goldman Sachs Mortgage Company**  
**Issuing Entity: GSAMP Trust 2007-H1**

Realized Losses: With respect to any date of determination and any Liquidated Mortgage Loan, the amount, if any, by which (a) the unpaid principal balance of such Liquidated Mortgage Loan together with accrued and unpaid interest thereon exceeds (b) the Liquidation Proceeds with respect thereto net of the expenses incurred by the applicable Servicer in connection with the liquidation of such Liquidated Mortgage Loan and net of the amount of unreimbursed Servicing Advances with respect to such Liquidated Mortgage Loan.

Liquidated Mortgage Loan: With respect to any Distribution Date, a defaulted Mortgage Loan (including any REO Property) which was liquidated or charged-off in the calendar month preceding the month of such Distribution Date and as to which the applicable Servicer has certified (in accordance with this Agreement) that it has made a Final Recovery Determination.

**Sponsor: IndyMac Bank, F.S.B.**  
**Issuing Entity: IndyMac INDX Mortgage Loan Trust 2006-AR12**

Realized Loss: With respect to each Liquidated Mortgage Loan, an amount (not less than zero or more than the Stated Principal Balance of the Mortgage Loan) as of the date of such liquidation, equal to (i) the Stated Principal Balance of the Liquidated Mortgage Loan as of the date of such liquidation, plus (ii) interest at the Adjusted Net Mortgage Rate from the Due Date as to which interest was last paid or advanced (and not reimbursed) to Certificateholders up to the Due Date in the month in which Liquidation Proceeds are required to be distributed on the Stated Principal Balance of such Liquidated Mortgage Loan from time to time, minus (iii) the Liquidation Proceeds, if any, received during the month in which such liquidation occurred, to the extent applied as recoveries of interest at the Adjusted Net Mortgage Rate and to principal of the Liquidated Mortgage Loan. With respect to each Mortgage Loan that has become the subject of a Deficient Valuation, if the principal amount due under the related Mortgage Note has been reduced, the difference between the principal balance of the Mortgage Loan outstanding immediately prior to such Deficient Valuation and the principal balance of the Mortgage Loan as reduced by the Deficient Valuation. With respect to each Mortgage Loan which has become the subject of a Debt

Service Reduction and any Distribution Date, the amount, if any, by which the principal portion of the related Scheduled Payment has been reduced.

To the extent the Servicer receives Subsequent Recoveries with respect to any Mortgage Loan, the amount of the Realized Loss with respect to that Mortgage Loan will be reduced by such Subsequent Recoveries.

Liquidated Mortgage Loan: For any Distribution Date, a defaulted Mortgage Loan (including any REO Property) that was liquidated in the calendar month preceding the month of the Distribution Date and as to which the Servicer has certified (in accordance with this Agreement) that it has received all amounts it expects to receive in connection with the liquidation of the Mortgage Loan, including the final disposition of an REO Property.

**Sponsor: Residential Funding Corporation**  
**Issuing Entity: RALI Series 2006-QA4 Trust**

Realized Loss: With respect to each Mortgage Loan (or REO Property): (a) as to which a Cash Liquidation or REO Disposition has occurred, an amount (not less than zero) equal to (i) the Stated Principal Balance of the Mortgage Loan (or REO Property) as of the date of Cash Liquidation or REO Disposition, plus (ii) interest (and REO Imputed Interest, if any) at the Net Mortgage Rate from the Due Date as to which interest was last paid or advanced to Certificateholders up to the Due Date in the Due Period related to the Distribution Date on which such Realized Loss will be allocated pursuant to Section 4.05 on the Stated Principal Balance of such Mortgage Loan (or REO Property) outstanding during each Due Period that such interest was not paid or advanced, minus (iii) the proceeds, if any, received during the month in which such Cash Liquidation (or REO Disposition) occurred, to the extent applied as recoveries of interest at the Net Mortgage Rate and to principal of the Mortgage Loan, net of the portion thereof reimbursable to the Master Servicer or any Subservicer with respect to related Advances, Servicing Advances or other expenses as to which the Master Servicer or Subservicer is entitled to reimbursement thereunder but which have not been previously reimbursed, (b) which is the subject of a Servicing Modification, (i) (1) the amount by which the interest portion of a Monthly Payment or the principal balance of such Mortgage Loan was reduced or (2) the sum of any other amounts owing under the Mortgage Loan that were forgiven and that constitute Servicing Advances that are reimbursable to the Master Servicer or a Subservicer, and (ii) any such amount with respect to a Monthly Payment that was or would have been due in the month immediately following the month in which a Principal Prepayment or the Purchase Price of such Mortgage Loan is received or is deemed to have been received, (c) which has become the subject of a Deficient Valuation, the difference between the principal balance of the Mortgage Loan outstanding immediately prior to such Deficient Valuation and the principal balance of the Mortgage Loan as reduced by the Deficient Valuation, or (d) which has become the object of a Debt Service Reduction, the amount of such Debt Service Reduction.

Notwithstanding the above, neither a Deficient Valuation nor a Debt Service Reduction shall be deemed a Realized Loss hereunder so long as the Master Servicer has notified the Trustee

in writing that the Master Servicer is diligently pursuing any remedies that may exist in connection with the representations and warranties made regarding the related Mortgage Loan and either (A) the related Mortgage Loan is not in default with regard to payments due thereunder or (B) delinquent payments of principal and interest under the related Mortgage Loan and any premiums on any applicable primary hazard insurance policy and any related escrow payments in respect of such Mortgage Loan are being advanced on a current basis by the Master Servicer or a Subservicer, in either case without giving effect to any Debt Service Reduction.

To the extent the Master Servicer receives Subsequent Recoveries with respect to any Mortgage Loan, the amount of the Realized Loss with respect to that Mortgage Loan will be reduced to the extent such recoveries are applied to reduce the Certificate Principal Balance of any Class of Certificates on any Distribution Date.

Cash Liquidation: As to any defaulted Mortgage Loan other than a Mortgage Loan as to which an REO Acquisition occurred, a determination by the Master Servicer that it has received all Insurance Proceeds, Liquidation Proceeds and other payments or cash recoveries which the Master Servicer reasonably and in good faith expects to be finally recoverable with respect to such Mortgage Loan.

**Sponsor: Wells Fargo Bank, N.A.**

**Issuing Entity: Wells Fargo Home Equity Asset-Backed Securities 2007-2 Trust**

Realized Loss: With respect to a Liquidated Mortgage Loan, the amount by which the remaining unpaid principal balance of the Mortgage Loan exceeds the amount of Net Liquidation Proceeds applied to the principal balance of the related Mortgage Loan. With respect to any Mortgage Loan, a Deficient Valuation or a reduction in the Principal Balance thereof resulting from a Servicer Modification.

Liquidated Mortgage Loan: As to any Distribution Date, any Mortgage Loan in respect of which the Servicer has determined, in accordance with the servicing procedures specified herein, as of the end of the related Prepayment Period, that all Liquidation Proceeds, Condemnation Proceeds and Insurance Proceeds which it expects to recover with respect to the liquidation of the Mortgage Loan or disposition of the related REO Property have been recovered.

Liquidation Proceeds: The amount (other than amounts received in respect of the rental of any REO Property prior to REO Disposition) received by the Servicer in connection with (i) the taking of all or a part of a Mortgaged Property by exercise of the power of eminent domain or condemnation or (ii) the liquidation of a defaulted Mortgage Loan by means of a trustee's sale, foreclosure sale or otherwise.

## APPENDIX II

Listed below are examples of PSA provisions that further adjust the aggregate certificate principal balance to equal the aggregate “scheduled” (or “stated”) principal balance of the loans. These provisions were taken from publicly filed transactions and are listed in alphabetical order based upon the name of the transaction’s sponsor. This appendix is not meant to provide a complete list of all transactions that contain this type of provision. It is recommended that each applicable PSA be reviewed in order to obtain a complete picture of the transaction.

**Sponsor: Countrywide Home Loans**

**Issuing Entity: CHL Mortgage Pass-Through Trust 2007-11**

Section 4.04 (b) The Class Certificate Balance of Subordinated Certificates then outstanding with the highest numerical Class designation shall be reduced on each Distribution Date by the sum of (i) the amount of any payments on the Class PO Certificates in respect of Class PO Deferred Amounts and (ii) the amount, if any, by which the aggregate of the Class Certificate Balances of all outstanding Classes of Certificates (after giving effect to the distribution of principal and the allocation of Realized Losses and Class PO Deferred Amounts on such Distribution Date) exceeds the Pool Stated Principal Balance for the following Distribution Date.

**Sponsor: IndyMac Bank, F.S.B.**

**Issuing Entity: IndyMac IMJA Mortgage Loan Trust 2007-A3**

Section 4.05(b) The Class Certificate Balance of the Class of Subordinated Certificates then outstanding with the highest numerical Class designation shall be reduced on each Distribution Date by the sum of (i) the amount of any payments on the Class PO Certificates in respect of Class PO Deferred Amounts and (ii) the amount, if any, by which the aggregate Class Certificate Balance of all outstanding Classes of Certificates (after giving effect to the distribution of principal and the allocation of Realized Losses and Class PO Deferred Amounts on such Distribution Date) exceeds the aggregate Stated Principal Balance of the Mortgage Loans for the following Distribution Date.