A Conversation about The Pooling and Servicing Agreement

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February 29, 2008: Important note:

Since this was written, the situation with loan modifications evolved rapidly, and many of the uncertain points discussed in this paper have been resolved or narrowed quite a bit. In particular, there has been a lot of thinking, at least for some types of subprime adjusable rate loans of when default is "reasonably foreseeable" such that a loan modification can be considered before any payments are actually missed.

The complete pooling agreement can be seen at http://www.sec.gov/Archives/edgar/data/1389138/000127727707000304/exh41to8kpsawamu07_he2.pdf

The views expressed in this paper are my own and do not necessarily reflect the views or opinions of Washington Mutual, Inc. nor any of its affiliates.

Background questions

So, what is a pooling and servicing agreement?

It's a contract. Someone who owns a pool of mortgage loans sells them through an intermediary to a trustee for the benefit of investors, and the seller or another party agrees to administer—service—the loans. Sometimes there's a separate party whose job it is to figure out which class of investors gets how much in what order. Otherwise, either the trustee or the servicer does that. You'll also hear it referred to as a PSA, a pooling agreement or a trust agreement.

What does it look like?

A municipal bond indenture on a really bad hair day. For a complicated deal it might be 400 pages long with the exhibits, not including the loan listing.

Is it hard to understand?

The parts that don't put you to sleep can make your head explode.

Why so long, boring and difficult?

History and tradition, the innate conservatism of lawyers and trying to turn cash flow models into word problems.

Do I have to read the whole thing to understand how it affects load modifications?

Fortunately, no. It's mainly a matter of knowing where to look and understanding the basic framework.

How?

Start with the overall structure. There are a dozen major pieces, and most of them can be completely or partially tossed for your purposes.

What are the pieces?

Here's the top level outline:

- Preliminary statement and definitions
- The exchange of loans for securities
- Servicing
- Distributions and reports
- Transfers of securities
- Limited liability of the servicer
- Events of default
- Limited liability of the trustee
- End of the deal
- Tax
- Boilerplate
- Exhibits

Let's start at the beginning. What do I look for in the preliminary statement?

Only a few things: Who is in the deal directly, date, name of the deal and a rough idea of how the investor classes break out.

What do I look for about investors?

You'll see one or more tables of classes of securities (which will probably be called "certificates," same thing). If there's more than one, it's to thread through the tax rules. Look for the last one, usually. The limited voting rights generally follow the balances, so the big balances are important in amendments, but loss exposure usually moves the other way.

Show me an example.

The I-A and II-A1, -A2, -A3 and -A4 certificates, with

the big balances at the top, will turn out to be AAA rated, highly unlikely to be exposed to credit loss and carry the lowest interest rates. Having an "A" in the name of your certificate invariably indicates a senior position in the payment food chain. The M certificates, in the middle, will turn out to have increasing credit risk and higher interest rates as you go down the column. This role is sometimes filled by "B" certificates. Either way, the lack of an "A" usually means a junior position. The "Class C Interest," at the bottom of the table is also the last to receive distributions and the first to have its balance written off by losses.

How do I find out who the actual investors are?

Not by reading the pooling agreement. For many classes, you can sometimes find out through one of the securities underwriters who they sold to. Since the cer-tificates are highly illiquid, this will often be who currently owns them. But they can be bought and sold after the initial offering, and it can take some digging with financial intermediaries to find out. For the other classes, the trustee will know, but may not tell.

How about the definitions?

Here be dragons. Experts can tell pretty much everything they need to know about deal specifics just by reading this section. Don't go there unless you need a specific term. But remember, whenever you see Capitalized Words, they don't mean what you think they do and you should come back here to find out. Unfortunately, many of the Capitalized Words use Additional Capitalized Words in their definitions, which, in turn ... . You get the idea.

What's next?

The piece that acts as a sort of constitution for the deal. The loans are conveyed to the trust in exchange for the certificates. The trustee agrees to hold the loans for the benefit of the investors. The trust is subjected to limits on its activities.

So this is a critical piece, right?

Right, we'll need to spend more time on it after finishing the high-level tour.

And next is servicing?

Yes, another critical piece we'll look at in more detail.

How about distributions and reports?

The ways in which this piece affects loan modifications, if at all, is completely deal specific and needs expert dissection. It's mainly a question of whose ox gets gored first; that is, the allocation of realized losses.

Transfers of securities?

You can almost always skip this section.

Limitations on liability of the servicer sounds like it's purely legal, am I right?

True, but there's another key concept it will be worthwhile to discuss.

And events of default?

Same.

Trustee liability?

Same.

The part about what happens at the end of the deal?

Same.

Tax.

One key provision.

Boilerplate?

Some important technicalities covering the role of the investor.

How about the exhibits?

The mortgage loan purchase agreement may have some relevance, but don't kill trees printing out the rest of it.

Framework questions

OK. Let's take the closer look. In order?

Yes, except we'll save the servicing section for the end.

Fine. Tell me about the section after the definitions, the constitution.

Good. We'll look at the actual language, then a translation, from one of WaMu's subprime deals. If you want to see the full document in all its splendor, there's a link at http://www.careaga.net/psaexample.pdf

> *Section 2.01 Conveyance of Mortgage Loans.*
>
> The Depositor, concurrently with the execution and delivery hereof, does hereby transfer, assign, set over and otherwise convey to the Trust, without recourse, all the right, title and interest of the Depositor, including any security interest therein for the benefit of the Depositor, in and to the Mortgage Loans identified on the Mortgage Loan Schedule, the rights of the Depositor under the Mortgage Loan Purchase Agreement (other than the Depositor's rights under Section 17 thereof) and all other assets included or to be included in REMIC 1. Such assignment includes all scheduled payments on the Mortgage Loans due after the Cut-off Date and all unscheduled collections in respect of the Mortgage Loans received after the Cut-off Date (other than the portion of such collections due on or prior to the Cut-off Date). The REMIC 1 Regular Interests, REMIC 1 Regular Interest IX and the Class R-1 Interest shall collectively be a separate series of beneficial interests in the assets of the Trust consisting of the Trust Fund assets included in the definition of REMIC 1 pursuant to Section 3806(b)(2) of the Statutory Trust Statute. The Depositor herewith delivers to the Trustee an executed copy of the Mortgage Loan Purchase Agreement and the PMI Policy.

Ugh. Let's do this one in full HD, but first, the point: "Hello. I'm handing over this stuff. It's now yours, not mine."

Next, whenever you see the word "REMIC," think "income tax." A real estate mortgage investment conduit avoids taxing mortgage payments twice (once when the trust receives them and a second time when the investor gets paid from them). Everything having to do with the REMIC is vital to the deal for that reason, but I'll highlight the only REMIC point that affects loan modifications. You can ignore 95+% of the sentences containing the word "REMIC." Looked at in that light, we're immediately shorter, and when we back out the legal flourishes, we're down to:

> The Depositor permanently transfers the Mortgage Loans, without recourse, to the Trust, along with its rights under the Mortgage Loan Purchase Agreement and the PMI Policy. The Depositor is entitled to any money received on the Mortgage Loans for scheduled payments due before the Cut-off Date.

Don't we have to check the capitalized words and phrases?

Right! We'll do that in a moment, but there's a hidden one that's sometimes a source of confusion—"without recourse."

What does that mean? If the Depositor represents that the Mortgage Loan is valid and it isn't, then the Trust doesn't

have recourse against the Depositor?

No, it means that if the borrower doesn't make payments, the Depositor doesn't have to; there's no recourse to the Depositor (or the seller under the mortgage loan purchase agreement) if the borrower is delinquent or in default. Breaches of representations and warranties are entirely separate, and they may entitle the Trust to repurchase of the mortgage loans or other remedies.

So it's not as simple as the Servicer just buying the loan out of the trust to be able to do modifications freely?

The servicer has no *right* to purchase a loan until the "clean-up call", when it can purchase the pool after it declines to a set percentage of the initial pool balance that is less than 10%. If the Servicer is also the Seller it *may* have an obligation.

Where would I find the Seller's obligations?

They are in a mortgage loan purchase agreement attached as an exhibit, although sometimes the Seller is a party, in which case the representations and warranties are included in the pooling agreement. There's an example MLPA at http://www.careaga.net/mlpa.pdf

Let's do the first set of defined terms. It sounds like we've been talking in them already.

Starting with parties ...

"Depositor": WaMu Asset Acceptance Corp., a Delaware corporation, or any successor in interest.

"Trust": WaMu Asset Backed Certificates WaMu Series 2007-HE2 Trust, a Delaware statutory trust, created pursuant to the Original Trust Agreement.

and continuing with what the Depositor deposits ...

"Mortgage Loan": Each mortgage loan transferred and assigned to the Trust and delivered to the Trustee or another Custodian pursuant to Section 2.01 or Section 2.03(d) as from time to time held as a part of the Trust Fund, the Mortgage Loans so held being identified in the Mortgage Loan Schedule.

"Mortgage Loan Purchase Agreement": The agreement between the Servicer, in its capacity as Seller, and the Depositor, regarding the transfer of the Mortgage Loans by the Seller to or at the direction of the Depositor, substantially in the form attached hereto as Exhibit C.

"PMI Policy": Policy number 07-993035 issued by the PMI Insurer in favor of the PMI Mortgage Loans.

And now, I suppose, we have to unpack those for yet additional defined terms?

Yup. Starting again with "who" ...

"Custodian": Deutsche Bank National Trust Company, or any other custodian appointed as provided in Section 8.11 hereof pursuant to a Custodial Agreement.

"PMI Insurer": Radian Guaranty Inc.

"Seller": Washington Mutual Bank, a federal savings association, or its successor in interest, in its capacity as seller under the Mortgage Loan Purchase Agreement.

"Servicer": Washington Mutual Bank, a federal savings association, or any successor servicer appointed as herein provided, in its capacity as Servicer hereunder.

"Trustee": Citibank, N.A., a national banking association, or its successor in interest, or any successor trustee appointed as herein provided.

Next, we'll catch up on the what's by exploding the rest of the defined terms, in order ...

"Trust Fund": All of the assets of the Trust, [you can stop here] which is divided into separate pools of assets consisting of REMIC 1, REMIC 2, REMIC 3, REMIC CX, REMIC PX, REMIC SwapX, the Reserve Fund, the Supplemental Interest Trust, the Final Maturity Reserve Trust, the Interest Coverage Account and any Servicer Prepayment Charge Payment Amounts and the Trust's rights un-

der the Swap Agreement.

"Mortgage Loan Schedule": As of any date, the list of Mortgage Loans included in REMIC 1 on such date, attached hereto as Exhibit D. The Mortgage Loan Schedule shall be prepared by the Seller and shall set forth the following information as of the Cut-off Date with respect to each Mortgage Loan, as applicable:

(i) the Mortgagor's name and the originator's Mortgage Loan identifying number;

{snip} and

(xxxi) with respect to each MOM Loan, the related MIN.

"PMI Mortgage Loans": The Mortgage Loans insured by the PMI Insurer set forth on the list of Mortgage Loans attached hereto as Schedule IV.

"Custodial Agreement": With respect to the initial Custodian, the Custodial Agreement, dated as of April 1, 2007, by and between the Trustee and Deutsche Bank National Trust Company, as custodian, and with respect to any other custodian, any agreement that may be entered into by the Trustee and any Custodian or any agreement assigned to the Trustee providing for holding and safekeeping of Mortgage Files on behalf of the Trust.

and, just in care you're wondering ...

"Mortgage File": The mortgage documents listed in Section 2.01 pertaining to a particular Mortgage Loan and any additional documents required to be added to the Mortgage File pursuant to this Agreement.

A key definition for the deal, but which doesn't much figure in the loan modifications analysis:

"Cut-off Date": With respect to each Closing Date Mortgage Loan, April 1, 2007; and with respect to each Substitute Mortgage Loan, its date of substitution, as applicable.

Finally, an undefined term, the abbreviation "PMI." It stands for private mortgage insurance, which is what Radian provides in this deal. It pays a portion of the principal losses on defaulted mortgage loans.

Whew!

I know, I know. And we didn't even finish, but we have enough to go back to Section 2.01 and fully translate our first attempt

> The Depositor permanently transfers the Mortgage Loans, without recourse, to the Trust, along with its rights under the Mortgage Loan Purchase Agreement and the PMI Policy. The Depositor is entitled to any money received on the Mortgage Loans for scheduled payments due before the Cut-off Date.

to

> WaMu Asset Acceptance Corp. permanently transfers the mortgage loans listed on the schedule, without recourse, to WaMu Asset Backed Certificates WaMu Series 2007-HE2 Trust, along with its rights under its purchase agreement for the mortgage loans with Washington Mutual Bank and the insurance policy issued by Radian. WaMu Asset Acceptance Corp. is entitled to any money received on the mortgage loans for scheduled payments due before April 1, 2007.

That's it? THAT'S IT?

Yeah, not really complex, only complicated.

It's just "A transfers x (the mortgage loans), y (the contract with B), and z (the insurance policy issued by C) to D (the trust) but retains a portion of y."

Pretty much a school logic question—four actors, three things, and the insurer and policy are not always part of the deal.

That's amazing. I won't ask how much you pay for the reverse translation back to legalese. I understand what mortgage loans are, and an insurance policy and an insurer. It's also easy to recognize WaMu the bank. What does the other WaMu entity do and why is it the Trust, rather than the Trustee?

WaMu Asset Acceptance Corp. is what's called a bankruptcy remote special purpose entity, one of those wicked SPEs that Enron abused. Although an SPE can be an essential step in taking assets off of the seller's balance sheet to hide the financial condition of an Enron, there is nothing nefarious about them when used properly. This corporation has a limited business, buying financial assets like mortgage loans from its affiliates and selling them to securitization trusts. For looking at how the pooling agreement bears on loan modifications, just think of them as a possibly necessary party that doesn't have an economic stake.

WaMu Asset Backed Certificates WaMu Series 2007-HE2 Trust is special in a difference sense. It is organized as a Delaware statutory trust.

Other trusts, "common law trusts," are simply an arrangement for one person to transfer property to a another person who agrees to hold it for the benefit of a third person. Put another way, the "grantor" or "settlor" conveys the "trust corpus" to the "trustee" "in trust for the benefit" of the "beneficiaries." This started out several hundred years ago as a way of circumventing inheritance laws. Let's just say that the law of trusts did not evolve in a simpler direction.

One of the attributes of a common law trust is that it is a relationship, not a separate legal entity. An important aspect of that relationship is that the beneficiaries, if they are united, can fire the trustee and take over the trust property in their own names.

How does the statutory trust differ?

Mainly in that the statutory trust is a separate legal entity in the same way a corporation is a separate legal entity. Its legal attributes, within the limits of the Delaware legislation, are in its charter document, which turns out to be the pooling agreement. This means that the mortgage loans stay in the trust until the pooling agreement says they can come out.

And that's what you meant when you described it as a "constitution"?

Yes. And to be tedious, I have to draw out the really, really important point. For payments due after April 1, 2007, Washington Mutual Bank does not own the mortgage loans, WaMu Asset Acceptance Corp. doesn't own the mortgage loans, neither trustee owns the mortgage loans and the investors don't own the mortgage loans. The trust owns the mortgage loans.

Then since the trust owns the mortgage loans, does that mean that the trust can just decide to modify mortgage loans if it wants to?

Not exactly. Like everything else in the world of the trust, everything is supposed to be in the pooling agreement. Plus, by design, the trust is "brain dead." Not only does the pooling agreement specify in detail what is supposed to happen, the trust doesn't have a governing body, like a board of directors, that ***can*** take any decision.

What about the trustee?

There are two, actually. The "Trustee" trustee, Citibank,

has exactly those duties, and no more, that are assigned to it in the pooling agreement. The "Delaware Trustee" trustee, Christiana Bank, is almost as inert as the trust itself. It's like being one of those ceremonial heads of state—there must *be* one but he or she isn't supposed actually to *do* anything.

Wait, don't tell me. We have to go through more pooling agreement.

Don't worry. It gets easier from here.

You said we would skip over the distributions section, because the details in each deal determine how each class of investor is differently affected. You also said that there was nothing interesting in the section dealing with the certificates and their transfer. What was it about the next section?

The next section deals with the liability of the servicer:

> *Section 6.01 Liability of the Servicer and the Depositor.*
>
> The Depositor and the Servicer each shall be liable in accordance herewith only to the extent of the obligations specifically imposed by this Agreement and undertaken hereunder by the Depositor and the Servicer herein.
>
> *Section 6.03 Limitation on Liability of the Depositor, the Servicer and Others.*
>
> None of the Depositor, the Servicer or any of the directors, officers, employees or agents of the Depositor or the Servicer shall be under any liability to the Trust Fund or the Certificateholders for any action taken or for refraining from the taking of any action in good faith pursuant to this Agreement, or for errors in judgment; provided, however, that this provision shall not protect the Depositor, the Servicer or any such person against any breach of warranties, representations or covenants made herein, or against any specific liability imposed on the Servicer or the Depositor, as applicable, pursuant hereto, or against any liability which would otherwise be imposed by reason of willful misfeasance, bad faith or negligence in the performance of duties or by reason of reckless disregard of obligations and duties hereunder.

On the one hand, the servicer can take comfort from these sections; its obligations are all in the pooling agreement and it won't be held to a standard of perfection. On the other hand, and this worries its lawyers no end, if the servicer goes beyond the explicit terms of the pooling agreement is it going to be held to a different standard?

Meaning more likely to be sued?

Yeah, and lose. That's the worry.

What are the events of default?

Events of default can get you fired as a servicer.

Obviously a Bad Thing. What are the consequences?

A terrible hit on reputation, having to write off a servicing asset (mortgage servicing rights are capitalized, so it's not just an opportunity cost—it goes straight to the bottom line, in non-accountant terms, not sure how it works technically), the expense of servicing transfer ***and*** it's hard on borrowers.

What triggers them?

Failing to remit or advance funds on time, some insolvency related contingencies, and "breach of covenant," a fancy term for not keeping a promise to do what you're supposed to do under the pooling agreement.

I've been meaning to ask. How hard is the vocabulary?

"Whereof your affiant states and declares upon other that, with respect to the aforementioned clause (vi) of subparagraph (b) of Section 2.01 of Exhibit A attached hereto

and the further agreements, understandings, covenants, conditions and premises therein adverted in furtherance thereof, upon oath, as follows:" Actually, aside from a sprinkling of those crusty fillers, not bad. Usually only a few thousand distinct words.

Back to defaults. What is the first thing to happen?

It gets fixed, pronto. The hard part usually is detecting it.

And if it can't be or isn't fixed, the servicer automatically is finished?

No. For one type of default, the trustee has to notify the servicer that it is terminated, and for others, a majority of the certificateholders (there are special rules for determining voting rights, including disregarding certificates held by affiliates of the sponsor). In the example we are using, the "NIMS Insurer" also has rights to terminate the servicer.

NIMS?

Net interest margin securities. In deals that use overcollateralization as a credit enhancement, the scheduled payments on the mortgage loans are more than needed to pay the principal and interest due on the certificates. One class, Class C in our example deal, gets whatever is left over. This is sometimes called a "residual," which is confusing because there is an entirely unrelated "REMIC residual." The owner of the Class C Certificate also invariably owns the Class P Certificate, which is entitled to prepayment penalties collected on mortgage loans that pay in full early. The owner transfers those certificates to a second trust or an offshore entity, such as a Cayman Islands corporation, depending on whether only one or more than one class of derivative securities, the NIMS, are to be issued. Going offshore is needed to avoid entity level taxation for reasons that are a mystery to all but the inner circle of tax specialists.

And who is the NIMS Insurer?

It's just an insurance company that issues a policy that will pay investors in the NIMS if the Class C and Class P Certificates throw off insufficient cash to pay off the NIMS. You'll sometimes hear this kind of insurer referred to as a "monoline."

Where does it end, who else has a say?

Sometimes, a rating agency has to sign off on changes in effect: "... *provided*, however that the Servicer shall obtain written confirmation that the Ratings will not be affected thereby ... ." Then, there are the circles within circles of the other derivative investors.

Such as?

Well, the NIMS typically has the securities from just the one underlying deal. But you can do the same thing with any number of classes from any number of deals and get a CDO, a collateralized debt obligation. And, of course, you can go on to create a CDO of CDOs, a synthetic CDO, where no one actually owns the reference securities, a hybrid, with some of each type or anything else within the imagination of the street. This means that the cast of characters who have a stake in the mortgage loans in a pool may be broader than just the initial holders of certificates.

How do they keep it all straight?

It's a Mystery. I'll let you know, right after I collect my Nobel Prize in Economics.

Let's go on. What's the next chunk?

The trustees:

> *Section 8.01 Duties of Trustees.*
>
> The Trustee, prior to the occurrence of a Servicer Event of Default known to the Trustee and after the curing of all Servicer Events of Default which may have occurred, undertakes to perform such duties and only such duties as are specifically set forth in this Agreement. During a Servicer Event of Default known to the Trustee, the Trustee shall exercise such of the rights and powers vested in it by this Agreement, and use the same degree of care and skill in their exercise as a prudent person would exercise or use under the circumstances in the conduct of such person's own affairs.
>
> Any permissive right of the Trustee enumerated in this Agreement shall not be construed as a duty.

This is the analog of the section on the duties of the servicer. The good news, from a trustee liability exposure perspective, is that unless it knows of an event of default, it only has to do what it's told to in the pooling agreement. The bad news, from the same viewpoint, is that the trustee can get in the situation where its conduct can be questioned: Is *that* what a prudent person would do?

Think of this as "In case of an Event of Default, Break Glass and Activate Trustee."

I take it that the trustee isn't very likely to volunteer to step in and solve a problem just because no one else is?

Unless it involves an event of default, the trustee may be actively engaged with other parties analyzing issues, but its role makes it very unlikely that it will actually take any action that it does not have to take.

The next section deals with what happens at the end of the deal. Doesn't the trust remain until the last mortgage loan is paid off or the last foreclosed property sold?

What if it can't be sold? Fortunately, there's a sunset:

> ... ; provided, however, that in no event shall the trust created hereby continue beyond the expiration of 21 years from the death of the last survivor of the descendants of Joseph P. Kennedy, the late ambassador of the United States to the Court of St. James, living on the date hereof.

You're kidding. What do the Kennedys have to do with it?

I have to chuckle. This is the infamous Rule Against Perpetuities:

> *No interest is good unless it must vest, if at all, within twenty-one years of a life in being at the time the instrument speaks.*

The two reasons to chuckle is that this common law rule of trusts is used to torture first-year law students and was the turning point in the mystery *Body Heat,* where Katherine Turner sets up John Hurt to take the rap by exploiting his lack of attention to detail on this point.

It makes sense that it wouldn't go on forever, but isn't it impractical when the pool gets very small?

It can be, so there's a rip cord provision that allows the servicer or, in some cases, a third party like the NIMS insurer, to purchase all the mortgage loans and foreclosed property when the pool reaches 10% or less. Usually, the larger the pool balance, the lower the threshold. This is the "clean-up call."

Pretty straightforward. What do I need to pay attention to in the tax section.

Recall that the point of having a REMIC is to avoid taxation of the trust of the payments on the mortgage

loans before those payments are passed on to investors to be taxed a second time. It's possible to break the REMIC rules in ways that jeopardize pass-through status or give rise to the dreaded "prohibited transaction tax."

What's prohibited?

Some dispositions of mortgage loans are taxable at 100% of the gain. The gain may not be very much, but it can take a lot of tax accounting horsepower to figure it out.

Who is responsible for the tax?

The trustee (i) or the servicer (ii), depending on who tripped over the rules, otherwise the investors (iii):

> (g) If any tax is imposed on prohibited transactions of any Trust REMIC created hereunder pursuant to Section 860F(a) of the Code, on the net income from foreclosure property of any such REMIC pursuant to Section 860G(c) of the Code, or on any contributions to any such REMIC after the Startup Day therefor pursuant to Section 860G(d) of the Code, or if any other tax is imposed by the Code or any applicable provisions of state or local tax laws, such tax shall be charged (i) to the Trustee pursuant to Section 10.03 hereof, if such tax arises out of or results from a breach by the Trustee of any of its obligations under this Article X, (ii) to the Servicer pursuant to Section 10.03 hereof, if such tax arises out of or results from a breach by the Servicer of any of its obligations under Article III or this Article X, or (iii) otherwise against amounts on deposit in the Distribution Account and shall be paid by withdrawal therefrom.

Then there is the yada yada yada boilerplate?

Some of this is great stuff! Well, one short section and one long. The pooling agreement is subject to Delaware law. That means whichever court might be hearing a case involving the pooling agreement would be applying Delaware law. Other pooling agreements are usually subject to the laws of New York state. No state has a huge body of law interpreting pooling agreements, but the concentration in the precedents of a few states makes interpreting pooling agreements somewhat more certain than if it were more spread out.

What's the long section?

Amendments. You can get a sense of how much a provision in the pooling agreement has evolved over time by how long the paragraphs run:

> *Section 11.01 Amendment.*
>
> This Agreement or any Custodial Agreement may be amended from time to time by the Depositor, the Servicer, the Trustee, the Delaware Trustee and, if applicable, the Custodian, with the consent of the NIMS Insurer, and if necessary, with the prior written consent of the Swap Counterparty (as described below), and without the consent of any of the Certificateholders, (i) to cure any ambiguity or defect, (ii) to correct, modify or supplement any provisions herein (including to give effect to the expectations of Certificateholders), or in any Custodial Agreement, (iii) to modify, eliminate or add to any of its provisions to such extent as shall be necessary or desirable to maintain the qualification of the Trust Fund as a REMIC at all times that any Certificate is outstanding or to avoid or minimize the risk of the imposition of any tax on the Trust Fund pursuant to the Code that would be a claim against the Trust Fund, provided that the Trustee, the NIMS Insurer, the Depositor and the Servicer have received an Opinion of Counsel to the effect that (A) such action is necessary or desirable to maintain such qualification or to avoid or minimize the risk of the imposition of any such tax and (B) such action will not adversely affect the status of the Trust Fund as a REMIC or adversely affect in any material respect the interest of any Certificateholder or (iv) to make any other pro-

visions with respect to matters or questions arising under this Agreement or in any Custodial Agreement which shall not be inconsistent with the provisions of this Agreement or such Custodial Agreement, provided that, in each case, such action shall not, as evidenced by an Opinion of Counsel delivered to the parties hereto and the NIMS Insurer, adversely affect in any material respect the interests of any Certificateholder, provided, further, that (A) such action will not affect in any material respect the permitted activities of the Trust and (B) such action will not increase in any material respect the degree of discretion which the Servicer is allowed to exercise in servicing the Mortgage Loans and, provided, further, that any such amendment which modifies the rights or obligations of the Delaware Trustee hereunder shall require the consent of the Delaware Trustee. No amendment shall be deemed to adversely affect in any material respect the interests of any Certificateholder who shall have consented thereto, and no Opinion of Counsel shall be required to address the effect of any such amendment on any such consenting Certificateholder.

Yuck. Let me translate this first, discarding the parts that don't directly concern us.

The Depositor, the Servicer, the Trustee and the Delaware Trustee can amend the pooling agreement with the consent of the NIMS Insurer and other affected third parties. The consent of investors is not needed in these cases:

(i) to cure any ambiguity or defect,

(ii) to correct, modify or supplement any provisions in the pooling agreement (including to give effect to the expectations of the investors),

(iii) to preserve the tax treatment as a REMIC or

(iv) otherwise amend the pooling agreement in a way consistent with its existing previsions

A formal legal opinion is required that the amendment will not adversely affect the interests of any investor who has not given a consent to the amendment. The permitted activities of the Trust may not be affected. The discretion that the Servicer is allowed to exercise in servicing the Mortgage Loans may not be increased.

That's clearer to me, at least.

In fairness to the lawyers who have labored over this language, including myself, the precision is important, but it can get in the way of understanding the essentials for a civilian.

The big picture seems to be that this is for changes that should be non-controversial.

That's right. Things as simple as a missing defined term, a nuance described in the prospectus that didn't get picked up, avoiding the double taxation hazards and similar fixes. The main thing is that the changes not change the economics of the deal.

The prohibition on changing the basic activities of the trust seems sensible, since that would be like amending its charter. But why the limits on changing the scope of discretion for the servicer?

You know, this is one of those things that rightly drives people nuts. These gotchas don't come with a user manual to explain why they crept into the agreement. You wonder if it's Dilbert's Pointy Hair Boss saying "*No one ever got fired for a decision that they declined to make. <u>Except</u> when it was optional.*"

But it's not that simple?

No, it reflects an accounting issue, actually. A lot of copier toner has been sprayed on this in the accounting literature, but not enough to settle the question:

If a transferor of financial assets has the power, with others, to treat the assets as if it still owned them, even

if it does not exercise that power, should the transfer be disregarded?

Apologies to my friends in accounting. In the workaday world, *everything* calls for discretion. Only we call it "interpretation."

I'm guessing that will turn out to be a big issue if people decide that the servicer needs more leeway to deal with loan modifications. Is that all there is in amendments?

No, there's a second procedure for amending the agreement with the consent of ⅔ of the investors as a whole and of each class whose payment entitlements are affected.

Does it have the same restrictions on charter amendments and servicer discretion?

Curiously, no, for reasons I need to catch up on.

Before we launch into the servicing section, can you recap?

The trust owns the mortgage loans. Of the four parties to the pooling agreement, two have very limited roles, a third, the trustee, has a limited role unless the fourth, the servicer fails to cure its default. Different investors are entitled to different priorities of payment. Third party credit enhancers, such as insurers, and others may have special rights of consent. Tax treatment imposes some limitations on what can be done. The trustee and the servicer are likely to be anxious about getting into gray areas. The ability to amend the agreement without the consent of investors is limited.

If you'd just said so, we could have saved a lot of time!

But would you have believed me?

Good point. On to servicing. Is there anything we can eliminate?

About ⅔ of the sections deal with routine matters like maintaining property insurance or special deal features like administering the swap agreements in the example deal. That leaves 11 sections to look at.

And the first one is?

The standing orders to the servicer in Section 2.01:

> *Section 3.01 Servicer to Act as Servicer.*
>
> The Servicer shall service and administer the Mortgage Loans on behalf of the Trust and in the best interests of and for the benefit of the Certificateholders (as determined by the Servicer in its reasonable judgment) in accordance with the terms of this Agreement and the respective Mortgage Loans and, to the extent consistent with such terms, in the same manner in which it services and administers similar mortgage loans for its own portfolio, giving due consideration to customary and usual standards of practice of mortgage lenders and loan servicers administering similar mortgage loans in the local areas where the related Mortgaged Property is located but without regard to:
>
> [here follows a list of factors, including affiliate relationships with the borrower or other parties, ownership by the servicer of certificates, obligations to make advances and rights to receive servicing compensation.]

What should I pay attention to in this section?

Several things: The servicer is responsible for servicing the mortgage loans for the trust. Other parts of the pooling agreement contemplate that the servicer may change, but it is always the person performing this role who has the duties and no one else. Second, the servicer is to bear in mind that the investors are the persons who have the economic interest in the mortgage loans. Third, the servicer has to work within the constraints imposed by the

terms of the mortgage loans individually and the pooling agreement. Fourth, the servicer processes the mortgage loans using the same methods as it uses for its own account, except where the pooling agreement requires a different method. Finally, the servicer takes into account how similar loans are serviced by others, according to local practices. (Remember that mortgage loans are subject to the laws of 50 different states and local requirements may vary within each state.)

So, the rules are let the servicer do its job, which is to follow the pooling agreement using its usual methods of servicing, paying attention to individual loan and local requirements and always remembering that other people are relying on it?

Right.

OK. What next?

Later on in the same section

> Notwithstanding anything in this Agreement to the contrary, the Servicer may not make any future advances with respect to a Mortgage Loan (except as provided in Section 4.04) and the Servicer shall not (i) permit any modification with respect to any Mortgage Loan that would change the Mortgage Rate, reduce or increase the principal balance (except for reductions resulting from actual payments of principal) or change the final maturity date on such Mortgage Loan (unless, as provided in Section 3.07, the Mortgagor is in default with respect to the Mortgage Loan or such default is, in the judgment of the Servicer, reasonably foreseeable) or (ii) permit any modification, waiver or amendment of any term of any Mortgage Loan that would both (A) effect an exchange or reissuance of such Mortgage Loan under Section 1001 of the Code (or final, temporary or proposed Treasury regulations promulgated thereunder) and (B) cause any Trust REMIC to fail to qualify as a REMIC under the Code or the imposition of any tax on "prohibited transactions" or contributions after the startup day under the REMIC Provisions.

What is a future advance?

Loaning more money to the borrower on the same loan, which is not a very common feature of mortgage loans any more. It actually has nothing to do with the types of advances mentioned in the Section 4.04 referred to in the parenthetical that crept in somewhere along the way.

If I can take a turn playing lawyer, it looks like the rest of it says no loan modifications at all if there are bad tax consequences in the (ii) clause and even if there are no bad tax consequences, no loan modifications unless there is a default situation?

Good.

What constitutes a "default"?

Another great question. A day late? Past the grace period? Thirty days' delinquent? Unpaid after foreclosure notice? What do you think?

You're the lawyer.

Then, I'll give you the lawyer answer, "It depends."

On what?

On the tax side, I'm told, the standard is "default or imminently foreseeable" and there's a respectable body of opinion that means any time after a loan is 30 days' delinquent.

Measured when?

It makes sense to use the OTS standard: a payment due on May 1, 2007 is delinquent if not received by close of

business on the last business day of the following month, *i.e.*, June 28, 2007.

Same rule for non-tax defaults?

I'm not sure that there's a consensus on that, yet. I'm not doing a legal memorandum here, just helping to see through all the dust. My hunch is that in the absence of a widespread industry consensus (what do "prudent lenders and servicers do?"), it is going to end up depending on what the servicer normally does on its own loans. That could be something like 180 days' delinquent or it might take into account judgments regarding the borrower, loan type, specific reasons for delinquency, local economic conditions, including real estate market trends, and possibly other factors.

What else bears on modifications?

The same subject gets taken up again in another section (more evolution at work):

Section 3.07 Collection of Certain Mortgage Loan Payments

> **[First sentence]** The Servicer shall make reasonable efforts to collect all payments called for under the terms and provisions of the Mortgage Loans, and shall, to the extent such procedures shall be consistent with this Agreement and the terms and provisions of any applicable insurance policies, follow such collection procedures as it would follow with respect to mortgage loans comparable to the Mortgage Loans and held for its own account. **[Second sentence]** Consistent with the foregoing, the Servicer may in its discretion (i) waive any late payment charge or, if applicable, any penalty interest, or (ii) extend the due dates for the Monthly Payments due on a Mortgage Note for a period of not greater than 180 days; provided that any extension pursuant to this clause (ii) shall not affect the amortization schedule of any Mortgage Loan for purposes of any computation hereunder, except as provided below. In the event of any such arrangement pursuant to clause (ii) above, the Servicer shall make timely advances on such Mortgage Loan during such extension pursuant to Section 4.04 and in accordance with the amortization schedule of such Mortgage Loan without modification thereof by reason of such arrangements, subject to Section 4.04(d) pursuant to which the Servicer shall not be required to make any such advances that are Nonrecoverable Advances. **[Third sentence]** Notwithstanding the foregoing, in the event that any Mortgage Loan is in default or, in the judgment of the Servicer, such default is reasonably foreseeable, the Servicer, consistent with the standards set forth in Section 3.01, may also waive, modify or vary any term of such Mortgage Loan (including modifications that would change the Mortgage Rate, forgive the payment of principal or interest or extend the final maturity date of such Mortgage Loan, **[sentence 3½]** accept payment from the related Mortgagor of an amount less than the Stated Principal Balance in final satisfaction of such Mortgage Loan (such payment, a "Short Pay-off") or consent to the postponement of strict compliance with any such term or otherwise grant indulgence to any Mortgagor; [**sentence 3¾**] provided, that in the judgment of the Servicer, any such modification, waiver or amendment could reasonably be expected to result in collections and other recoveries in respect of such Mortgage Loans in excess of Net Liquidation Proceeds that would be recovered upon the foreclosure of, or other realization upon, such Mortgage Loan and **[sentence 3⅞]** provided further, that the NIMS Insurer's prior written consent shall be required for any modification, waiver or amendment if the aggregate number of outstanding Mortgage Loans which have been modified, waived or amended exceeds 5% of the number of Closing Date Mortgage Loans as of the Cut-off

Date.

What does this add?

The first, long sentence states the obvious—the preference is to collect all payments originally called for by the mortgage loan. The second sentence authorizes payment plans, so long as the servicer continues to advance. The third sentence re-authorizes loan modifications for default situations, then in sentence 3½, we get the authority to accept less than full payment on the loan. Sentence 3¾ gives some guidance on what the best interests of the investors requires by setting the test of whether modifying the mortgage loan leaves the investor, as well as the borrower, better off than if foreclosure and sale of the property went forward. Finally, sentence 3⅞ brings the NIMS insurer into the decision when loan modifications reach 5% of the original pool count.

You were starting to run out of fractions, there.

Like I say, this is what you see after many years of cumulative tweaks.

What other sections in servicing?

There's this one, just as a reminder is that one form of modification is having the mortgage loan assumed by a different borrower. All we really need is the title:

Section 3.15 Enforcement of Due-On-Sale Clauses; Assumption Agreements.

What's "due on sale."

Technically, it's an acceleration clause: "OK, you sold the home, now pay off the entire balance because the new owner can't just take over the payments." Same issue, really, as modfication, which is are we better off keeping the loan, rather than foreclosing on the property?

OK. I sense we're getting to the end.

Close.

Section 3.16 Realization Upon Defaulted Mortgage Loans.

(a) The Servicer shall use reasonable efforts consistent with the servicing standard set forth in Section 3.01 to foreclose upon or otherwise comparably convert the ownership of properties securing such of the Mortgage Loans as come into and continue in default and as to which no satisfactory arrangements can be made for collection of *de*linquent payments pursuant to Section 3.07.

If modification doesn't work, foreclosure?

Yes. Later in Section 3.16, the most junior investor gets the opportunity to control its own fate:

(c) The Holder of the Class C Certificates (except if such Holder is the Seller or any of its Affiliates) may at its option purchase from REMIC 1 any Mortgage Loan or related REO Property that is 90 days or more delinquent or that has been otherwise in default for 90 days or more, which such Holder determines in good faith will otherwise become subject to foreclosure proceedings (evidence of such determination to be delivered in writing to the Trustee prior to purchase), at a price equal to the Purchase Price; provided, however, that the Holder of the Class C Certificates shall purchase any such Mortgage Loans or related REO Properties on the basis of delinquency or default, purchasing first the Mortgage Loans or related REO Properties that became delinquent or otherwise in default on an earlier date. For the avoidance of doubt, the Holder of the Class C Certificates in exercising its right to purchase Mortgage Loans pursuant to this Section 3.16(c) shall not be subject to any requirement of this Article III (other than the requirements of this Section 3.16(c)). In the event the Holder of the Class C Certificates does not exercise its option to purchase from REMIC 1 any such Mortgage Loan

or related REO Property, the NIMS Insurer shall be entitled to purchase such Mortgage Loan or related REO Property; provided, however, that the NIM Insurer shall purchase any such Mortgage Loans or related REO Properties on the basis of delinquency or default, purchasing first the Mortgage Loans or related REO Properties that became delinquent or otherwise in default on an earlier date. The Purchase Price for any Mortgage Loan or related REO Property purchased hereunder shall be deposited in the Collection Account, and the Trustee, upon receipt of written certification from the Servicer of such deposit, shall release or cause to be released to the Holder of the Class C Certificates or the NIMS Insurer, as applicable, the related Mortgage File and the Trustee, on behalf of the Trust, shall execute and deliver such instruments of transfer or assignment, in each case without recourse, as the Holder of the Class C Certificates or the NIMS Insurer, as applicable, shall furnish and as shall be necessary to vest in the Holder of the Class C Certificates or the NIMS Insurer, as applicable, title to any Mortgage Loan or related REO Property released pursuant hereto. For so long as the indenture trustee under the Indenture is the Holder of the Class C Certificate, the holder (the "Residual NIM Holder") of the subordinate note, the owner trust certificate or another instrument representing the right to receive the proceeds of the trust estate securing payments on the NIM Notes after all of the NIM Notes have been paid off shall be deemed to be the "Holder of the Class C Certificates" for purposes of this Section 3.16(c). The Trustee shall request from the Residual NIM Holder a certificate substantially in the form of Exhibit G attached hereto. The Trustee may conclusively rely upon and shall be fully protected in acting or refraining from acting based on such certificate.

This long paragraph gives first the Class C certificates (in other deals it may be the Class-B6, for example), then the NIMS Insurer and, finally, the Residual NIM Holder the right to direct the servicing at 90 days' delinquent. Since these will end up absorbing any losses, they can act solely in their self-interest without worrying about the rest of the investors.

Makes sense. Back to the servicer, though, what happens if it makes a loan modification that is not authorized?

It's on the hook for the difference:

Section 3.25 Obligations of the Servicer in Respect of Mortgage Rates and Monthly Payments.

In the event that a shortfall in any collection on or liability with respect to any Mortgage Loan results from or is attributable to adjustments to Mortgage Rates, Monthly Payments or Stated Principal Balances that were made by the Servicer in a manner not consistent with the terms of the related Mortgage Note and this Agreement, the Servicer, upon discovery or receipt of notice thereof, immediately shall deliver to the Trustee for deposit in the Distribution Account from its own funds the amount of any such shortfall and shall indemnify and hold harmless the Trust, the Trustee, the Depositor and any successor servicer in respect of any such liability. Such indemnities shall survive the termination or discharge of this Agreement. Notwithstanding the foregoing, this Section 3.25 shall not limit the ability of the Servicer to seek recovery of any such amounts from the related Mortgagor under the terms of the related Mortgage Note, as permitted by law and shall not be an expense of the Trust.

What's left?

The signoff of Radian on the loans it insures:

Section 3.28 PMI Policy; Claims Under the PMI Policy.

Notwithstanding anything to the contrary elsewhere in this Article III, the Servicer shall not agree to any modification or assumption of a PMI Mortgage Loan or take any other action with respect to a PMI Mortgage Loan that

could result in denial of coverage under the PMI Policy. The Servicer shall notify the PMI Insurer that the Trustee, as trustee on behalf of the Trust, is the insured, as that term is defined in the PMI Policy, of each PMI Mortgage Loan. The Servicer shall, on behalf of the Trust, prepare and file on a timely basis with the PMI Insurer, with a copy to the Trustee, all claims which may be made under the PMI Policy with respect to the PMI Mortgage Loans. The Servicer shall take all actions required under the PMI Policy as a condition to the payment of any such claim. Any amount received from the PMI Insurer with respect to any such PMI Mortgage Loan shall be deposited by the Servicer, no later than two Business Days following receipt thereof, into the Collection Account. On each Servicer Remittance Date, the Servicer shall pay to the PMI Insurer the PMI Insurer Fee for such Distribution Date from the amounts on deposit in the Collection Account prior to transferring any amounts in the Collection Account to the Trustee for deposit into the Distribution Account.

Is that it?

That's it.

Not as bad as I thought.

Hope this helps.