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MORTGAGE BANKERS ASSOCIATION

Loss Mitigation Strategies in a Stressed Environment

presented by Jordan D. Dorchuck, Senior Vice President, Lehman Brothers

AURORA LOAN SERVICES

A Lehman Brothers Company

Loss Mitigation Strategies

- Dodd Principles – after subprime loan delinquencies, defaults, and foreclosures had started to soar, due in part to lax underwriting and declining home values, resets of hybrid 2/28 ARMs with low teaser initial interest rates, and general market conditions in various locations throughout the country, Sen. Dodd, chairman of the Senate Banking committee, held a homeownership preservation summit and on May 2, 2007, issued a "Statement of Principles" that several national, large home loan servicers agreed to follow. The principles are:

  - Early contact – servicers to contact borrowers prior to loan reset to determine if the borrower can afford the new payment or whether the higher payments create a reasonable risk of default.
  - Modify to create long-term affordability – the objective of a modification should be to create a permanent solution for the borrower "rather than, for example, deferring the rate reset period." Options may include:
    - switching from an ARM to a fixed rate at an affordable rate by, "for example, making the introductory rate permanent."
    - reducing the interest rate, taking into account the debt-to-income ratio
    - reducing the principal to ensure affordability and a continued revenue stream
    - reamortizing the loan to make the payments more affordable
    - escrowing for taxes and insurance to ensure sustainability.

- Dedicated Teams - Servicers to have dedicated teams or resources to handle mods on the scale required timely; servicers should partner with third party counselors and non-profits to make outreach effective.
- Refinancing to prime loans to eligible borrowers should be stream-lined and low-cost.
- Credit Availability - GSEs should work with lenders to make credit available through new products and expanded programs to allow borrowers to re-finance out of resetting subprime ARMs. FHA should provide insurance where possible. GSEs should buy subprime loans and modify them.
- Maximize success, minimize damage - Where it is not possible to prevent foreclosure, the parties should work to minimize damage to borrowers, communities and the mortgage market.
- Accountability - Progress on achieving these principles should be tracked.

A servicer's response to the Dodd Principles

- So, what are we doing?
  - Early Contact – we contact borrowers whose loans are due to reset in 75 days with payment increases of 25% or more to ask if they anticipate an inability to afford the new payment as a result of the payment shock. We have changed the name of our loss mitigation unit to the Home Retention Group" ("HRG").
  - Modify – HRG decision matrix enhanced to focus on requirements for modifications; reviewed hundreds of pooling and servicing agreements to determine servicer discretion to modify loans when default is reasonably foreseeable or during default and built a net present value test to determine whether the resulting cash flow after a mod would be reasonably expected to provide a greater net return to the bondholders, as a group, than the expected net liquidation proceeds would be after foreclosure and REO sale. The decision to allow a mod as opposed to recommending a house disposition strategy is determined after a review of the borrower's financials and related credit information to ascertain whether the borrower will have the ability to repay the loan as modified.
  - Dedicated Teams or Resources – we hired experienced and highly competent staff and managers, enhanced the training for these individuals, introduced an incentive-based comp program to encourage resolution of defaults and anticipated defaults, developed a staffing model to ensure that we are appropriately staffed to handle the expected volume of activity as a result of our early warning letter campaign and the levels of defaults in the portfolio, added a credit counseling referral process to Customer Service, Collections, and HRG, and established a dedicated toll-free number for early warning letter campaign respondents, Colorado foreclosure hotline, and foreclosure and bankruptcy counsel network.

- Refinancing - we streamlined our appraisal process and expanded our refinance team.
- Credit Availability – Lehman works closely with the GSEs to deliver new products. A recent example of governmental response is that, on August 31, 2007, President Bush announced a new "FHA Secure" program to refinance eligible borrowers who are in default as a result of a reset in their existing hybrid ARM loans. To be eligible, borrowers must need to demonstrate on-time payment history prior to the reset, at least 3% cash or equity in the home, a sustained employment history, and sufficient income to make the new mortgage payment, and initial rate resets need to occur between June 2005 and December 2009.
- Maximize success – we work with our property protection vendors to encourage defaulted borrowers to call to discuss work-out options, and HRG works with our borrowers to exit gracefully where saving the home is not the appropriate or economically practicable solution, thus avoiding the cost and disruption of a foreclosure proceeding.
- Accountability – we have work-in-process reporting to provide detailed aging and tracking through the entire home retention process, we are tracking the responses to our early warning letter campaign, and we have reporting in place to detail the number of different loss mit strategies used to resolve default and the breakage rate of each.

Loan Mods in Depth

- Loan mods are but one of several work-out strategy home retention devices. Typically, they would allow for a reduction in rate, or principal balance, or an extension of term (but no longer than the deal into which the loan has been securitized), or would change from an ARM to a FR loan, or capitalize the arrearage and add it to a balloon payment at the end of the term of the loan. But, because a loan mod will result in a permanent reduction in cash flow over the life of the loan it is not the favored approach to handle a borrower in financial distress. Of course, with a 2/28 hybrid ARM that is about to reset and for which the borrower is not able to afford the new payments, it may be the only remedy.

- Because most subprime loans are packaged and sold into securities, the servicer needs to be mindful of its contractual obligations. The governing document, usually called a pooling and servicing agreement, permits a servicer to enter into modifications if the loan is in default or if default is reasonably foreseeable. Usually, the document will also provide that any modification must be in the best interests of the bondholders or is not materially adverse to the interests of the security holders. The industry has thus far concluded that this test is to be read against the holders in the aggregate and not for each particular class, with different classes bearing different levels of risk in the deal. Some subprime deals limit mods to no more than a certain percentage of loans in the deal, usually 5%.

- FAS 140, an accounting standard, requires that to maintain off-balance sheet sale treatment of the assets deposited into a securitization trust, the seller must not retain any control over the assets and not exercise discretion (through its servicer) to modify any asset in the pool unless the asset is in default or default is reasonably foreseeable. The Chairman of the SEC issued a letter, dated July 24, 2007, in which he confirmed the position of the Financial Standards Accounting Board that modifying a loan where default is reasonably foreseeable should be consistent with the nature of modification activities that would have been permitted if a default had occurred and, thus, would not result in a requirement for entities to account for those securitized assets on their balance sheets.

- Fitch issued a report, dated June 4, 2007, regarding the practice of modifications of subprime loans in securitizations and S&P recently requested comment on its proposed requirements relating to reporting loan mods in securitizations. Both rating agencies recognize the importance that loan mods can play but caution that because investors will bear the loss of cash flow, the servicers need to have appropriate loss mitigation policies and procedures in place and report the extent and severity of loan mods appropriately so that the deals' ratings can be re-examined.

- On September 4, 2007, the FDIC, Federal Reserve Board, OCC, OTS, NCUA, and Conference of State Bank Supervisors issued a joint statement on loss mitigation strategies for servicers of residential mortgage loans that reside in securitizations. This statement referenced previous guidance by these regulators and the SEC letter; the agencies encourage loan servicers to use the authority under the governing securitization documents to take appropriate loss mitigation action similar to the actions suggested in the Dodd Principles. Interestingly, the agencies noted that sme loss mitigation strategies, such as forgiveness of debt, may result in additional tax liabilities for the borrower that should be included in an assessment of the borrower's ability to repay.

- Fannie Mae, however, may take a different view of the appropriateness of loan mods. In an announcement issued August 18, 2007, Ann. 07-03R2 (Reissue), Fannie amended section 502.02 of its Servicing Guide to provide that a loan mod may not occur while a loan is current and that a loan needs to be 4 months in default before a loan mod can be entertained and that the loan must be removed from the MBS pool and either reclassified as a Fannie Mae portfolio mortgage or repurchased by the servicer before a loan mod may be entered into.

Summary of Loss Mit Work-Out Strategies

APPROACH

- If the customer wants to keep the house, can afford the home, and is able to make the scheduled payment after a period of financial distress has ended, then the servicer usually considers a repayment plan or a forbearance plan. If the customer is unable to make the scheduled payments, then a loan modification might be suitable.

- If the customer wishes to keep the house, but cannot afford the home, and is willing to work with the servicer, then disposition strategies such as a short sale, deed in lieu and cash for keys might be suitable. Or, if the inability to pay is the result of a hybrid ARM resetting to an unaffordable rate, a loan modification should be considered.

- Only if the customer does not want the house and is unwilling to work with the servicer, should foreclosure be considered. The customer service objective is to work out the loan before referring for foreclosure.

Common Resolution Options

- Full Reinstatement of the Loan
- Partial Reinstatement of the Loan
- Repayment Plan – for customers whose financial distress is temporary, this plan allows the customer to repay, typically only 2-3 missed payments, over a set period while also making timely full monthly payments. Works only if the customer has the cash flow to make higher combined payments for a period of time.
- Forbearance Agreement – allows customers who have experienced a major life event, such as a disaster, job loss, or illness, to repay missed payments while at the same time making timely full monthly payments. Usually, the delinquency is more severe than with a repayment plan and the term of the forbearance is longer than the term of a repayment plan. Sometimes, the forbearance will be to suspend or reduce payments to allow the customer time to sell the house or refinance out of the loan.
- Loan Modification – may be the only remedy for subprime borrowers whose hybrid ARMs are about to reset. Selected when the servicer has concluded that the loss arising from a mod will be less than the potential loss of foreclosing and liquidating the property. Servicers need to determine the payment amount the customer can afford and that there is a strong likelihood of repayment.
- Refinance-Not likely, however, if customer is not a prime borrower and if the value of the real estate has declined.
- Short Sale – allows for the property to be sold by the borrower at less than the amount need to payoff the loan. The borrower must demonstrate an inability to afford the home and a lack of assets to make up the difference between the payoff amount and the sales price. A short sale avoids the delay of working through the foreclosure process and it avoids foreclosure and liquidation expense.
- Deed-in-lieu – reduces foreclosure and eviction costs and timelines.

Concluding Observations

- Declining home values and tightening credit standards on new originations have reduced refinancing opportunities for many borrowers. We will see more borrowers requiring either alternate work-out strategies or assistance in removing themselves from the home.

- Loan mods are but one alternative of loss mit strategy and home retention is but one kind of work-out. Sometimes, the borrower will not be able to afford the loan and there is not a compelling reason to modify it to a below-market deal.

- Servicers need to act in the best interests of the investors. NPV test should address that standard.

- Staffing and out-reach need to be enhanced industry-wide.