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SERVICING ADVANCE FACILITIES ARE BECOMING MORE COMMON

Servicing advance transactions, in which mortgage servicers securitize their rights to reimbursement for advances made to U.S. residential mortgage-backed security (RMBS) trusts, are becoming a more common financing type within the RMBS sector. Their increased use partly reflects the financial strain advancing responsibilities are placing on servicers as a greater portion of residential mortgages have become delinquent. While servicers are obligated to advance missed payments to RMBS trusts monthly, full reimbursement of these advances may take months or, in some cases, years depending on reimbursement method.

Advances arise because mortgage servicers are responsible for making certain payments to RMBS trusts when borrowers fail to make loan and other payments. Advance types include principal and interest (P&I), tax and insurance (T&I, also known as escrow advances) and corporate payments which are costs associated with foreclosing on and liquidating mortgage collateral. The servicer remits P&I advances monthly to RMBS trustees and makes T&I and corporate payments as needed to secure and preserve the mortgage collateral. RMBS transaction documents specify which collections (pool-wide or loan-specific) are used to reimburse servicers for each advance type. The obligation to reimburse servicers for advances from designated collections generally falls ahead of payments to RMBS security holders and other transaction participants. This enables servicers to securitize their rights to advance reimbursements at high investment grade rating levels. High investment grade ratings can be achieved as long as certain conditions, legal and structural features and overcollateralization levels are in place.

Although servicers are reimbursed for advances before RMBS security holders are paid, servicing advance transactions are not without risk. Important credit considerations include which collections are designated to pay servicing advance note holders and whether they are subject to delays, reductions or interruptions. Such risks can materialize from a servicer's financial condition and operational procedures, as well as from poor RMBS pool performance or nuances in the RMBS transactions that generate the advance receivables pledged to the servicing advance trust. Servicing advance transactions also contain liquidity exposure. Liquidity risks are two-fold: 1) reimbursements of servicing advances are non-interest bearing, while servicing advance securities do carry interest; and 2) a timing mismatch exists between expected remittances to the servicing advance trustee and note holder payment obligations.

Servicing advance notes often are issued under master trusts and enable issuance of additional series with equal payment priority. Typically, interest is due monthly and, absent an event of default, principal amortization commences after a revolving period in which new receivables are added to the trust. Once amortization begins, funds that would have been used to buy new receivables prior to amortization are instead redirected to pay note principal.

Due to the revolving nature of the receivables, minimum overcollateralization tests are established for each advance reimbursement type. This dampens the effect of dramatic shifts toward delayed recovery advances following note issuance.

Principal is due upon the stated final maturity, generally 5-10 years after issuance, though some note maturities are even longer. The ultimate principal repayment feature is important given the potential for cash flow interruptions due to servicer-related risks and reduces (though does not eliminate) the likelihood of liquidity events. While notes often accelerate only upon consent of the majority (or other threshold) of holders or servicer bankruptcy, the trustee may also have the ability to liquidate the collateral to pay off the notes in full. The longer final maturity helps alleviate risks that the receivables' liquidation value plummets and/or recoveries are significantly delayed during a servicer event and allows for extra time to resolve a servicing transfer or insolvency event.

DBRS believes a servicing transfer on a small portion of the RMBS trusts is a surmountable risk to the servicing advance transaction if the servicer has ample other RMBS trusts from which to generate receivables in order to sufficiently overcollateralize the notes. This may arise if a nominal percentage of the servicer's deals contain performance triggers and the triggers are breached. On the other hand, transfer of servicing rights to the bulk or all of the servicer's mortgages pledged to the servicing advance trust is a potentially severe situation. Under this scenario, the risk of lengthy cash flow interruption to the servicing advance transaction escalates.

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