

U.S. Structured Finance Newsletter

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SERVICER ADVANCES IN RMBS

In most U.S. Residential Mortgage-Backed Securities (RMBS), the servicer is required to advance delinquent principal and interest (P&I) to the trustee to the extent it is deemed recoverable. The servicer is also expected to make escrow advances for delinquent taxes and insurance (T&I) in addition to corporate advances for reasonable "out-of-pocket" expenses incurred by the servicer in the performance of its servicing obligations in connection with a default, delinquency, or other unanticipated event, including but not limited to, foreclosure proceedings and fees associated with the management and liquidation of any REO property (including legal fees).

Methods of reimbursement are specified in RMBS legal documents. Typically, servicers are reimbursed for advances in one of two ways: (1) monthly from general collections on the pool of mortgages (pool-level recovery) or (2) from subsequent collections on the related delinquent mortgage loan after it has been liquidated or when it reinstates (loan-level recovery). Though variations exist, P&I recoveries commonly are pool-level, while T&I and corporate are loan-level. Additionally, RMBS servicing agreements frequently specify that the servicer recovers any previously unreimbursed advances when a mortgage loan is modified, regardless of the specified reimbursement type.

Most RMBS transactions permit the servicer to be reimbursed for advances at the top of the trust payment waterfall. The speed at which servicer advances are reimbursed depends upon the type of advance and the foreclosure timeline in the jurisdiction where the related mortgaged property is located. For example, judicial advances are slower to collect through foreclosure than non-judicial advances; pool-level P&I advances are typically reimbursed much sooner than corporate and T&I advances which are reimbursed primarily through liquidation proceeds.

Presently, high delinquency rates and increased foreclosure and real estate owned (REO) timelines are causing liquidity challenges for many servicers that are advancing into RMBS. Loan-level recoveries on servicing advances can take several years. Additionally, the interest cost to carry relative to the servicer's credit facility can become a serious financial burden. Consequently, many issuers are weighing the benefit of advancing versus not advancing (P&I) in new RMBS transactions. While servicer advances are intended to provide timely cash flows and liquidity to a transaction, they do not serve as credit support. Furthermore, deals where advancing occurs typically have higher loss severities than those that do not because the advanced interest will have to be reimbursed from the trust upon the liquidation of the mortgage. As a result, DBRS has seen a growing number of inquiries with respect to transactions where servicers are not required to advance any P&I payments.

DBRS will continue to monitor the industry for its acceptance of deals without P&I servicer advances and the related impact on loss severities and timing of cash flows to the capital structure.

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