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Servicing Advance Receivables Now Eligible Collateral Under TALF

On March 19, 2009, the Federal Reserve Bank of New York expanded the list of collateral eligible for pledge under its TALF program to include, among other things, servicing advance receivables. A funding under the TALF program is structured as a loan from the Federal Reserve Bank of New York to an eligible borrower — which includes any U.S. company that owns eligible collateral and maintains an account relationship with a primary dealer.

In order to qualify as eligible collateral, servicing advance receivables must relate to principal, interest, tax, insurance or corporate advances on residential mortgage loans. Receivables must have been generated by Fannie Mae- or Freddie Mac-approved residential mortgage loan servicers on or after January 1, 2007. The servicer must be contractually entitled under its servicing agreement to be reimbursed for its advances on a first priority basis out of any insurance or liquidation proceeds and, if such proceeds are insufficient, from the general collections on the loan pool covered by the servicing agreement. Advances must be reimbursed from the underlying trust on a "first-in, first-out" basis.

The discount or haircut applied to collateral pledged under TALF varies between asset classes. For servicing advance receivables, the discount ranges from 12 percent for an expected asset maturity of less than one year to 16 percent for an expected asset maturity of four to five years. Borrowers will have the option of selecting a fixed interest rate (three-year LIBOR swap rate plus 1 percent) or a floating interest rate (one-month LIBOR plus 1 percent).

Hunton & Williams LLP has handled more than 36 servicer advance financing facilities since 2001, representing servicers, lenders, investors and placement agents, and recently we have closed a number of servicer advance financing facilities, using a variety of legal structures. Servicer advance financing facilities provide critical liquidity to mortgage loan servicers.

In order to ensure continuity of payment to securityholders, mortgage loan servicers in residential mortgage-backed securities transactions generally are obligated to advance delinquent principal and interest payments and to make certain servicing advances relating to the preservation and maintenance of mortgaged properties (*e.g.*, taxes, insurance, foreclosure costs). Advancing obligations can create significant liquidity challenges for servicers of subprime mortgage loans, which historically have experienced higher delinquency and default levels than other types of mortgage loans. The ongoing surge in borrower delinquencies in the subprime

mortgage loan industry has resulted in servicers' advancing obligations increasing to unprecedented levels over the last 18 months. Many of these servicers have considered various alternatives to offset their liquidity challenges and have decided to finance their rights to be reimbursed for any principal and interest advances or servicing advances.

The structures for advance financing facilities have run the gamut from revolving lines of credit (or repurchase facilities) secured by a pledge or sale of the servicer's advance receivables attributable to specified servicing agreements, to securitization structures, including master trust structures allowing combinations of term ABS and revolving variable funding notes.

In the case of the revolving lines of credit structures, the documentation looks like that of many other secured revolving loans. Typically the amount available to be borrowed is based on a "borrowing base" equal to the aggregate "collateral value" of the advance receivables. The "collateral value" of the advance receivables is equal to a percentage of the face amount of the receivable (*e.g.*, 85 or 90 percent). A servicer is required to pay down the principal of the revolver when the advance receivables are collected, and may re-borrow funds under the revolver to fund new P&I advances and servicing advances, until the end of the "revolving period" (which is typically the earlier of a pre-determined date or the occurrence of an event of default or another early amortization event specified in the loan documents). After the revolving period ends, the servicer is required either to pay off the entire loan in one lump-sum payment (obtained through refinancing the line of credit or otherwise), or to pay down the principal in equal monthly or quarterly installments over an amortization period.

Many sophisticated lending institutions, including most of the Wall Street banks, often will prefer to structure an advance financing facility as a securitization (a purchase by the bank of securities backed by the advance receivables). These facilities are structured like a typical securitization, involving the transfer of the receivables to one or more special purpose entities, or SPVs, organized to be "bankruptcy-remote" from the servicer. The SPV issues the securities backed by or representing interests in the pool of receivables. In light of the dislocation in the credit markets, and in the subprime mortgage market particularly, the requirement that these types of facilities be structured to be bankruptcy remote is becoming increasingly prevalent.

Hunton & Williams LLP is regularly listed among the nation's leading securitization law firms. The firm has represented issuers, underwriters, trustees, master servicers, securities insurance companies and other participants in thousands of public and private asset securitization transactions involving a wide variety of assets and more than $1 trillion in securities. Hunton & Williams represents some of the most significant private and governmental participants in the mortgage-backed and asset-backed securities capital markets. The structuring of advance financing facilities raises complicated issues regarding UCC, tax, bankruptcy and securities laws, and Hunton & Williams has the experience and knowledge to assist with these financing structures.

If you are interested in learning more about advance financing facilities, please contact one of the attorneys listed on this alert. For more information, please visit the Financial Industry Recovery Center at www.huntonfinancialindustryrecovery.com or our asset securitization practice area description at www.hunton.com.

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