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The impact of servicer advancing on private label RMBS

Investors who own or purchase private label Residential Mortgage-Backed Securities (RMBS) should pay attention to the potential impact of servicer advances on the future cash flows of mortgage-backed securities. Although an asset-backed bond may be paying timely principal and interest and have sufficient credit enhancement, a high servicer advance level can be a signal the servicer may stop or reduce advancing at some point in the near future causing the security to experience payment shortfalls.

The level of servicer advances on distressed mortgages is often significant and has been continuing at a high level for a number of years. In these cases, investors may get a false sense of security that servicer advances will continue at the current level. The servicer may stop advancing at their discretion resulting in cash flow shortfalls to investors.

What is a servicer advance?

A servicer advance occurs when the servicer of a mortgage loan advances funds due and not yet received from the borrower under a securitized mortgage, to the bond Trustee for distribution to the investors.

Servicer advances most frequently are for principal and interest payments but also include payments for property taxes, insurance, attorney fees, or other costs necessary to maintain the property's value and/or protect the Trust's security interest.[1]

The current month advances are usually aggregated and reported in the trustee report. According to most Pooling & Servicing Agreements ("PSAs"), the repayment of funds advanced by the servicer are generally near the top of the cash flow waterfall and afford the servicer a senior claim against the Trust (ahead of the claims of senior note holders).

Why does the servicer advance these payments?

In most transactions, the servicer is obligated to advance payments under the servicing contract unless it deems such advance to be unrecoverable. If the servicer believes the advances will not be repaid, it will cease to advance resulting in a cash flow shortfall.

Standard language in a RMBS PSA reads:

> *"The servicer will be required to advance delinquent payments of principal and interest on the loans and advance any property protection expenses relating to the loans.*
>
> *The trustee solely in its capacity as successor servicer (and any other successor servicer) will advance its own funds to make advances if the servicer fails to do so (unless it deems the advances to be nonrecoverable) as required under the pooling and servicing agreement.*
>
> *These cash advances are only intended to maintain a regular flow of scheduled interest and principal payments on the certificates and are not intended to guarantee or insure against losses.*
>
> *The servicer (and the trustee as successor servicer and any other successor servicer, if applicable) will not be required to make any advance that it determines would be nonrecoverable. The servicer will also be required to pay compensating interest to cover prepayment interest shortfalls to the extent of its servicing fee."*[2]

[1] DBRS US Structured Finance Newsletter, Volume 5, Issue 32, August 24, 2009, "Servicer Advances in RMBS" Kathleen Tillwitz, Quincy Tang, Claire Mezzanotte.

[2] Securities and Exchange Commission, Form 424B5, Securitized Asset Backed Receivables LLC Trust 2007-BR3, page S-19, SEC Accession No. 0000914121-07-001449, June 13, 2007.

Servicers agree to advance funds as a customary responsibility under the servicing agreement. Most Pooling & Servicing Agreements allow the servicer to receive late charges, extension fees, modification fees, and bonuses paid by the Federal government for modifying loans under the Home Affordability Modification Program ("HAMP") and other programs. They also generally have access to the borrower to facilitate marketing efforts for other products. The assessment of the economics of servicing considers all direct and indirect benefits.

Portfolio delinquencies remain at high levels with ongoing pressure and incentives to modify loans. Delinquent pools require more effort to service and the lack of payments reduce fee income.

Mortgage servicing requires economies of scale for a servicer to efficiently manage the portfolio as it is labor-intensive, regulated, and relies heavily on technology. Labor and compliance costs have increased over the past 10 years, and when combined with declining portfolio balances, can result in a rise in the average cost of servicing a loan (especially when troubled borrowers are involved). In the current environment, the need to maintain sufficient scale has been key to maintaining profitability in the sector (but alas a different topic for another day).

How do servicer advances affect RMBS?

Servicer advances are generally beneficial to the investor and support the trust in making timely principal and interest (P&I) payments to investors. A significant level of servicer advance activity can create a false sense of comfort among bond holders regarding the proceeds available once service advances are repaid and mortgage balances are written-off.

As the percentage of past due borrowers rise, generally so does the percentage of servicer advances. Delinquent loans, if not brought current, refinanced, or modified, are generally written-off. As the mortgage moves through the foreclosure/REO process, the servicer may continue making advances (on P&I payments, and also property taxes, insurance, attorney fees, and maintenance costs) until the property is eventually liquidated.

Upon liquidation, the servicer is normally repaid by the Trustee the amount it has advanced, leaving the remainder of the proceeds to the remaining note holders. If the property's estimated resale value is insufficient to pay-off the mortgage balance plus outstanding service advances, then the servicer generally will stop advancing funds.

What are the risks?

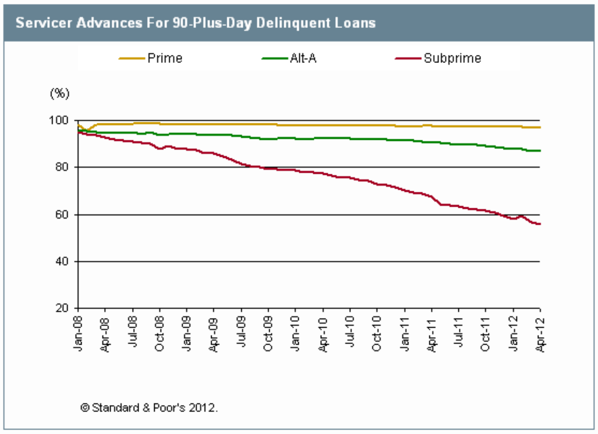
Mortgage-backed transactions with a high percentage of delinquent mortgages (i.e., greater than 30%) generally do not generate sufficient cash flow to fully pay investors timely P&I and protect the trust's security interest in the properties by paying property taxes and other fees. Most PLRMBS securitization trusts depend on the servicer to continue to advance payments to avoid principal and interest shortfalls.

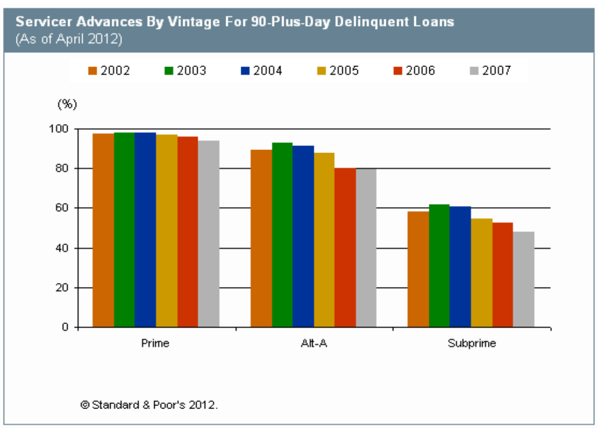
When the delinquency on a mortgage rises and ages beyond 360 days past due, servicers analyze the underlying mortgage balance, property value, outstanding servicer advances, carrying costs, and resolution timeline to determine when to stop making advances. If these factors suggest the servicer will not recoup its costs when the collateral is liquidated, then the servicer will generally stop advancing.

Servicers have to finance their operations, and a decline in servicing fees coupled with the obligation to make substantial advances can stress their liquidity. A servicer's access to funding can be a key consideration in their decision to stop advancing. Most servicing advance lines of credit require a pledge of the servicer's right to reimbursement from the Trust for advances resulting in the lender securing a senior claim against these cash flows from the Trust.

All servicer advance facilities/lines of credit have a cost – and commitment fees, annual fees, and usage/non usage fees can be a burden for servicer. Once the servicer reaches its credit limit, future advances by the servicer become uncertain.

Currently the level of Credit Crisis delinquencies has resulted in many servicers paying substantial sums to the RMBS trusts, essentially injecting liquidity into the structure for the benefit of investors. The servicer advance obligation has grown to such a degree that it is stressing servicer advance facilities. According to Standard & Poor's (S&P), servicer advances on private label subprime mortgages aged over 90 days past due has declined from approximately 95% in January 2008 to below 60% in April 2012.[3]





A couple of observations: There is a notable reduction in advances to deals labelled subprime or Alt-A. These deals generally have higher levels of delinquencies and lower expected net recoveries upon liquidation.

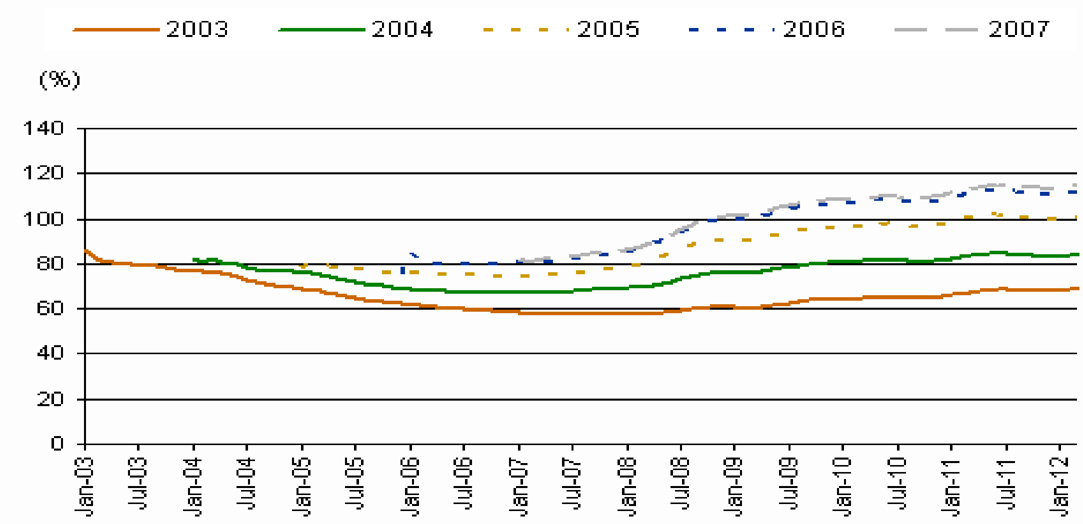
Investment professionals and industry participants need to ensure they consider the risk in their cash flow modelling assumptions, and perhaps factor in a haircut to the current advance levels, in making their determination as to when to assume the advances will terminate.

The analysis of RMBS securities should include a component to address the risk to the servicer advance assumption, and should consider the following:

- The overall delinquency of the pool and the percentages of mortgages aged over 90 days, in foreclosure, REO, and in bankruptcy as well as the seasoning of delinquent loans. The higher the level of serious delinquencies, the higher the probability the servicer will stop advances on the mortgages. The trend on roll rates into serious delinquency may be helpful in estimating future performance and an increasing trend in the aged buckets it is an indicator of heightened risk.
- The level of monthly and cumulative outstanding servicer advances reported in the distribution report can be useful in the evaluation of future cash flows of the trust. A useful analytic is a comparison of current month servicer advances to the current month scheduled P&I and cash collections.
- The aggregate outstanding servicer advances (if data is available) should be compared to the principal balance of the pool.
- The percentage of the pool where the servicer has stopped advancing (stop advance data is not always disclosed).
- The weighted average Housing Price Index ("HPI") updated LTV ratio of the mortgage loan pool provides insight into the potential recovery of proceeds from liquidated properties. The weighted average LTV ratio of the pool should be compared to the level of outstanding servicer advances. A high level of outstanding servicer advances will contribute to deal stress with a pool that has a high HPI Updated LTV (there is a higher probability the servicer will cease advancing on high LTV mortgages as the advances are not expected to be recovered).

[3] Standard & Poors Rating Services, June 15, 2012, *U.S. RMBS Credit Quality Rests on Several Key Housing Market Trends*. Vandana Sharma, Jeremy Schneider, and Kevin Leibowitz

Mark-To-Market Loan-To-Value Ratios For Subprime Loans



Source: CoreLogic.

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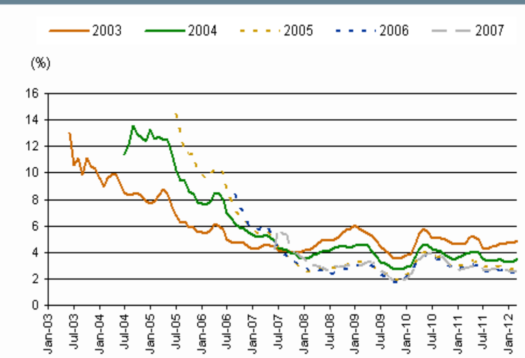
- The weighted average Combined Loan-to-Value (CLTV) Ratio is generally less meaningful to servicers than the LTV ratio. The CLTV ratio includes subordinated second liens. The ratio is an indicator of the level of indebtedness of the borrower and the potential impact in future default rates. Borrowers with first and second mortgage balances exceeding the value of the home are more likely to default as they are financially stressed. Trusts with mortgages containing high CLTVs are at higher risk of servicer advance terminations as a result of higher expected foreclosures.
- Excessive loan modifications and capitalization of interest into the principal balance are negative indicators and can lead to reduced future advances, higher loss severities, and lower borrower or collateral cash flows.
- The percentage of subprime mortgage delinquency cures has declined since 2003 while the re-default/recidivism rate among borrowers receiving loan modifications remains high according to data from CoreLogic and the OCC (as seen in charts below). Borrower stress leads to payment delays and increases the level of foreclosures (liquidations).

Cure Rates For Subprime Loans



Source: CoreLogic.

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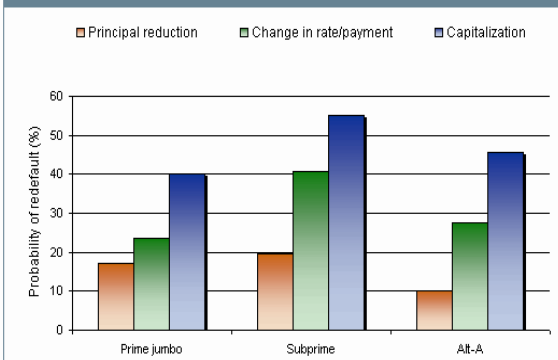
Recidivism Rates For Loans Within 12 Months Of Modification*



*Includes only the first modification for any loan. "Change in rate/payment" includes modifications that involved both a change in the payment amount and capitalization of missed interest. Source: CoreLogic.

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According to data prepared by the OCC, the level of serious delinquency on previously modified mortgages remains high.

OCC mortgage metrics report[4]

Table 2. Status of mortgages modified in 2008–3Q 2012

	Total	Current	30–59 days delinquent	Seriously delinquent	Foreclosures in process	Completed foreclosures	Paid off	No longer in the portfolio*
2008	445,354	22.6%	4.9%	12.8%	9.5%	15.7%	3.8%	30.7%
2009	594,350	34.3%	6.2%	15.2%	9.5%	11.0%	2.9%	20.9%
2010	939,364	46.9%	7.2%	14.2%	8.1%	6.4%	1.7%	15.5%
2011	564,065	57.0%	8.1%	15.8%	7.0%	2.4%	1.0%	8.7%
2012	335,095	74.3%	9.3%	11.6%	2.1%	0.2%	0.3%	2.2%
Total	2,878,228	45.7%	7.1%	14.2%	7.7%	7.3%	2.0%	16.1%
HAMP modification performance compared with other modifications**								
Other Modifications	1,431,669	49.7%	8.3%	16.7%	7.8%	5.8%	1.7%	9.9%
HAMP Modifications	663,619	60.8%	6.4%	9.4%	4.9%	2.8%	0.9%	14.8%
Modifications that reduced payments by 10 percent or more								
	1,763,586	53.4%	7.1%	12.3%	6.2%	4.8%	1.4%	14.7%
Modifications that reduced payments by less than 10 percent								
	1,114,642	33.5%	6.9%	17.1%	10.0%	11.2%	3.0%	18.3%

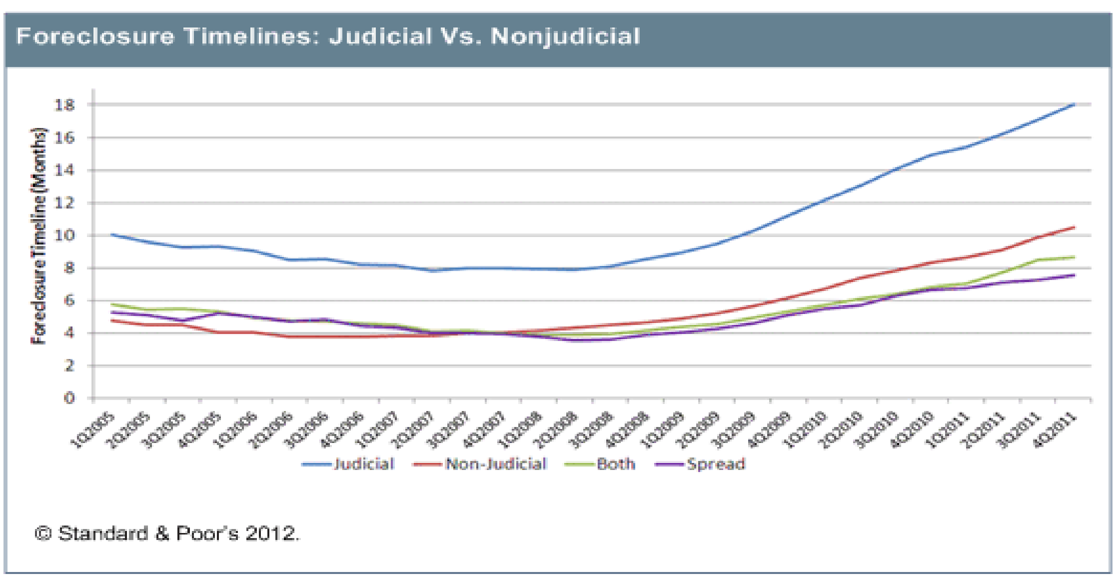
Source: US Treasury, Office of the Comptroller of Currency (OCC)

*Processing constraints prevented some servicers from reporting the reason for removal from the portfolio.

**Modifications used to compare with HAMP modifications include only modifications implemented from the third quarter of 2009 through the third quarter of 2012.

The number of mortgage loans currently in foreclosure in a trust directly affects the level of servicer advances. Foreclosure timelines extended over the past 3 years in judicial and non-judicial states. A delay in foreclosure activity leads to a higher percentage of funds that must be advanced to the trust. As advances on mortgages in a state of foreclosure increase, the likelihood of future advances declines.

Chart 12



[4] Office of the Comptroller of the Currency, March 2013, *OCC Mortgage Metrics Report, Third Quarter 2012*

"Judicial foreclosure is a court proceeding that begins when lender files a complaint and records a notice in the public land records announcing a claim on the property to potential buyers, creditors, and other interested parties."[5]

There are 22 states that require judicial procedures be utilized as the primary method for foreclosure. These judicial states include: Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Vermont, and Wisconsin.

The remaining states foreclosure requirements are non judicial (at least initially) and are established by state statute with no court intervention. Given the legal process associated with Judicial foreclosure, the foreclosure process in these states tend to take longer to complete than foreclosures in Non judicial states as evidenced in the chart above. [6]

[5] Mortgage Bankers Association, Judicial Versus Non-Judicial Foreclosures, 10/21/2010, pages 2-3.

[6] Mortgage Bankers Association, Judicial Versus Non-Judicial Foreclosures, 10/21/2010.

How does the level of servicer advances affect RMBS values?

Adjustments to expected cash flows to take into account termination of servicer advance rates on private label RMBS can significantly impact a security's estimated value and price. Below we will explore the impact the level of servicer advances can have on two different deals.

Example Deal 1

For our first example, we assume a subprime residential mortgage-backed security with serious delinquencies of over 56%. Deal 1 has collateral with a 110% HPI Updated LTV ratio and over 32% in foreclosure.

The investor report issued by trustee indicates servicer advances of approximately $1.37 million ($792K in interest advanced compared to $1.305 million scheduled interest due and $236K in principal advanced by the servicer compared to approximately $248K scheduled).

A high percentage of a portfolio's scheduled P&I funded by servicer advances is heavily reliant on the servicer to make payments. Aggregate outstanding servicer advances were not disclosed in the investor report.

The chart below reflects how the servicer advance rate can affect the security's price.

DEAL1	Asset type	Security description	Target yield	CPR	CDR	Loss severity	Servicer advance rate	Price
Scenario 1	RMBS	Subprime 2006 Vintage Sr. Class A Floater	5 to 10%%	1.0%	10.0%	80.0%	100%	$56.64
Scenario 2	RMBS	Subprime 2006 Vintage Sr. Class A Floater	5 to 10%%	1.0%	10.0%	80.0%	45.0%	$27.40

Using a target yield of 5.0 to 10% and assumptions based on recent performance, a servicer advance rate of 100% results in a price of $54.64 for Scenario 1.

In Scenario 2, a 45% servicer advance rate results in a bond price of $27.40 – a figure approximately 50% lower than the price with the higher servicer advance assumption.

Example Deal 2

Our second example, Deal 2, is a senior Alt-A fixed rate residential mortgage-backed security with 20.1% in 60+ delinquency, 12.2% in Foreclosure, 103.4% HPI Updated LTV ratio, and 31.4% non-performing/re-performing collateral.

Using an expected yield of 5 to 10.0%, and a 10% CDR curve, 75% loss severity, and 5% prepayment rate based on recent performance, the following bond prices were estimated:

Deal 2	Asset type	Security description	Target yield	CPR	CDR	Loss severity	Servicer advance rate	Price
Scenario 1	RMBS	Alt-A 2006 Vintage Sr. Fixed Rate Note	5.0 – 10.0%	5.0%	10.0%	75.0%	100.0%	$60.93
Scenario 2	RMBS	Alt-A 2006 Vintage Sr. Fixed Rate Note	5.0 – 10.0%	5.0%	10.0%	75.0%	45.0%	$46.10

A downward adjustment to the servicer advance level with all other assumptions held constant results in a price decline from $60.93 to $46.10 or over 24% lower. Again, the security values vary widely when the servicer advance rate assumption is modified.

Given the impact servicing advancing can have on a security's value, PwC recommends increased transparency on reporting of servicer advances. Reg. AB II became effective with the passage of the Dodd Frank bill and many elements of mortgage securitization disclosure and reporting were standardized. However, mortgage servicing advances and the method used to determine and report servicing advances has not significantly improved.

Conclusion – how long can servicers continue to advance at present levels?

Prior to 2007 pre-Credit Crisis, servicers would generally advance moderate amounts to RMBS Trusts relative to the total cash collections and monthly scheduled P&I with reimbursements following shortly afterward when the borrower became current with his/her mortgage payment.

Rising home prices made it easier for servicers to work with borrowers to modify mortgages and/or liquidate properties. Since 2008, servicers have had to deal with a high level of serious delinquency and lengthy foreclosure time lines, leading to a higher degree of servicer advances.

Servicer advances remain high relative to pre-crisis levels, with heightened risk from borrowers who cannot refinance and trusts left with lower credit quality mortgage collateral. Stay tuned as the servicers may further scale back their level of servicer advances to reduce their risk of over-advancing.

As the level of outstanding servicer advances approaches a loan's or pool's net property values, servicers will likely deem their advances to be non-recoverable and stop advancing. Such a scenario may result in more loans being written-down and losses being realized by the remaining note holders.

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