

# U.S. Structured Finance Newsletter

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## **LIQUIDATING TRUSTS: A PRACTICAL ALTERNATIVE FOR FUNDING NON-PERFORMING MORTGAGES**

Mortgage lenders holding seriously delinquent loans in portfolio face strategic difficulties as the liquidity crisis continues. In the past, lenders have sought liquidity in these positions via: (1) the whole loan market or (2) the debt capital markets. In the debt capital markets, lenders can issue bonds securitized by mortgaged properties in order to finance a loan portfolio. Most mortgage securitizations are formed as qualifying special purpose entities (QSPE), which offer favorable accounting treatment such as off-balance sheet recognition. However, a QSPE may only contain pool(s) of current and delinquent-yet-performing loans. For non-performing loans, an off-balance sheet securitization is not an option given certain accounting provisions.<sup>1</sup> A less common third choice is the liquidating trust structure, which remains on-balance sheet. In light of the turbulent credit markets, lenders may look to liquidating trusts to find critical funding from third parties.

Borrowers who are seriously delinquent by more than 90 days on their mortgage payments are classified generally as either: (1) performing in virtue of their restructured repayment schedule or (2) non-performing. A delinquent loan is considered performing once the borrower has satisfied at least three of the last four payments under a workout plan administered at the discretion of the servicer. In contrast, a non-performing borrower has not demonstrated a capacity to repay as a result of his default on the obligation. The servicer of a defaulted mortgage will commence with foreclosure proceedings on the mortgaged property, which is recognized as real estate owned (REO) upon eviction of the occupant. The servicer manages the liquidation of an REO property to maximize the recovery value of the collateral. Given the certainty of default of a non-performing mortgage, the servicer is not obligated to advance for delinquent monthly remittances of interest and principal. Thus, the only expected cash flow from a non-performing mortgage is the liquidation proceeds from the sale of the mortgaged property and any insurance proceeds.

A practical alternative for a lender to fund a portfolio of non-performing loans is a liquidating trust structure given the expectation of foreclosure on the mortgage assets of the trust. Although a mortgage trust may fail to meet QSPE status if its long-term assets include non-performing loans, the control and disposition of a non-performing loan portfolio is permitted in a liquidating trust, which is a form of an owner trust securitization.

The funding of a liquidating trust is accomplished by the issuance of notes and represents indebtedness of the lender. While a liquidating trust is funded by third parties through the sale of notes, a liquidating trust and its residual interests remain on balance sheet. Since a liquidating trust may be comprised of one or more pools of non-performing loans, its expected cash flow depends on the liquidation timing of the defaulted mortgaged properties. The notes can assume a senior-subordinate structure and may have forms of credit enhancement including (but not limited to) overcollateralization, subordination and a reserve fund. DBRS anticipates an increased usage of the liquidating trust structure going forward as issuers refocus their mortgage securitization efforts.

For questions or comments, please contact Bernard Maas at [bmaas@dbrs.com](mailto:bmaas@dbrs.com).

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<sup>1</sup> FAS 140 excludes a QSPE from permanently holding assets likely to default (Paragraph 41).