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In Practice

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Growth of UK NPL market

Subprime mortgages have been almost exclusively associated with the housing market in the US to date. However, with the magnitude of the current global financial crisis becoming clearer and the likelihood of recession in the UK looming ever larger, there is an increasing focus on the growth of a subprime mortgage market in the UK as well. This has attracted investors who are interested in trading in non-performing loans ('NPLs') at significant discounts to par. This article will specifically focus on factors to be considered by a purchaser when structuring the acquisition of residential real estate asset backed NPLs.

RESTRICTIONS IN THE UNDERLYING LOAN AGREEMENT

The first consideration when structuring the deal should be whether there are any restrictions on the type of entity to which the NPL can be transferred.

The most straightforward structure is for the purchaser to acquire both the legal and beneficial title to the NPL. However, due to restrictions on transfer in the underlying loan agreement, this may not always be possible. For example, the seller (who may or may not be the original lender of the NPL) may insist on remaining the lender of record to protect against any reputational damage. This is increasingly likely where the NPL portfolio in question comprises residential mortgage loans and the purchaser is intending to acquire the NPL using a special purpose vehicle ('SPV').

If the seller is to retain the legal title to the NPL, the deal can be structured so that the purchaser takes only an equitable assignment of the mortgage and agrees to only perfect such assignment in certain circumstances, for example, if the seller becomes insolvent. Retention of the legal title to the mortgage loans by the seller is not always preferable to the purchaser on the basis that a purchaser's objective in acquiring a portfolio of NPLs may be to enforce the mortgage loan and realise the underlying asset as quickly as possible. If the seller remains the legal owner, responsibility for servicing the mortgage loans and initiating enforcement procedures will also remain with the seller. The risks associated with the seller retaining control of the enforcement process can be mitigated by the seller granting a power of attorney in favour of the purchaser and agreeing to act in accordance with the purchaser's directions. However, such measures are time-consuming to agree and potentially increase the transaction costs for the purchaser.

REGULATORY CONSIDERATIONS

In addition to considering any restrictions in the underlying loan agreement, restrictions imposed by regulatory regimes also need to be considered when structuring the deal.

A residential mortgage is a 'regulated mortgage contract' (defined by art 61(3) (a) of the Financial Services and Markets 2000 (Regulated Activities) Order 2001) and the entry into a 'regulated mortgage contract' or the administration of a 'regulated mortgage contract' is a 'regulated activity' which has to be carried out by a Financial Services Authority ('FSA') regulated entity.

Purchasers of NPL portfolios are often SPVs which are not FSA-regulated entities as the purpose of such SPVs is to hold title to the NPLs until the underlying asset has been realised. From a regulatory perspective, it is possible to draw a distinction between acquiring the legal/beneficial interest in an existing regulated mortgage contract and making a new mortgage to the borrower. Care needs to be taken in varying the terms of existing mortgages since this can be deemed to be the creation of a new mortgage, which is a regulated activity. For instance, lending further advances would be likely to constitute entering into a new mortgage contract. However, it is unlikely that a lender will want to make further advances to a non-performing borrower.

> "Retention of the legal title to the mortgage loans by the seller is not always preferable to the purchaser."

While there is no regulatory requirement for the purchaser of a regulated mortgage contract to be FSA regulated, the purchaser will need to engage an FSA regulated servicer to administer and service the regulated mortgage contracts.

TAX CONSIDERATIONS

It is also important to consider withholding tax. Interest received from the borrower is regarded as UK source income which gives rise to an obligation to withhold. There are obviously exemptions to this obligation, although commonly investors in NPLs will be foreign SPVs. Careful thought therefore needs to be given as to how to structure transactions.

CONCLUSION

While the structure of an NPL trade will largely depend on the underlying asset securing such loan, structural considerations such as regulatory requirements, taxation and the terms of the underlying loan agreement will always be of paramount importance in deciding on the most efficient way to structure the trade. ■

Biog box

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