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Financial Services

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Advantages of Mortgage Repurchase Facilities

The past decade has seen a marked expansion in the use of warehouse financing facilities utilizing repurchase agreements. These specific types of facilities need to be structured carefully but enjoy a number of benefits that are not available to other types of warehouse facilities.

WHAT IS A REPURCHASE AGREEMENT?

The term “Repurchase Agreements” (also called “repos” and “repurchase and securities contracts”) is a collective term for financing facilities that are structured to satisfy and utilize certain safe harbor protections (as further discussed below) under the United States Bankruptcy Code of 1978 (the “Bankruptcy Code”). Under a typical Repurchase Agreement, certain eligible assets are sold by an entity (the “Seller”) to a qualifying counterparty (the “Buyer”) with a simultaneous agreement that the assets must be repurchased by the Seller on a date certain (the “Repurchase Date”) for the remaining amount owed to Buyer with respect to such asset (the “Repurchase Price”). Depending on when the Repurchase Date occurs, the agreements and transactions may qualify as either a “securities contract” (as defined in section 741(7) of the Bankruptcy Code) or a “repurchase agreement” (as defined in section 101(47) of the Bankruptcy Code). The Seller is often set up as a special purpose vehicle in order to provide the Buyer further bankruptcy protections.[1]

WHAT ASSETS QUALIFY?

The Bankruptcy Code lists several asset classes that qualify for safe harbor treatment, including mortgage loans, interests in mortgage loans, securities, certificates of deposit, a group or index of securities or mortgage loans and interests therein. This alert focuses on mortgage loans and interests in mortgage loans, a form of repurchase financing that has proved critical to the mortgage industry.

WHAT ARE THE DIFFERENCES BETWEEN A REPURCHASE AGREEMENT AND A SECURITIES CONTRACT?

Although, as noted above, the colloquial industry reference to "Repurchase Agreements" is used as a collective term to mean both a "Repurchase Agreement" and "Securities Contract", the Bankruptcy Code includes a specific definition of each, and specific safe harbors for each. For any such agreement to enjoy the safe harbor benefits afforded under the Bankruptcy Code to that kind of agreement, it needs to strictly conform to the applicable definition. There are, however, two main distinctions:

- Repurchase agreements must have a Repurchase Date not later than one year after the date the asset is purchased by the Buyer (section 101(47)(A) of the Bankruptcy Code).
- Securities contracts may have a Repurchase Date that is later than one year, but the Buyer must be a qualifying entity, most commonly a financial institution or a financial participant (section 555 of the Bankruptcy Code).

WHAT ARE THE BANKRUPTCY CODE BENEFITS OF REPURCHASE AGREEMENTS?

At its core, the safe harbors enable a repo Buyer who is faced with a Seller in bankruptcy to exercise a number of rights and protect funds already received from being clawed back in a manner that is not available to a non-safe harbored agreement. For example, pursuant to sections 555 of the Bankruptcy Code (applicable to Securities Contracts) and section 559 of the Bankruptcy Code (applicable to Repurchase Agreements), a repo Buyer facing a Seller in bankruptcy is permitted to:

- Accelerate the Repurchase Date so all amounts owed to the Buyer are immediately due;
- Terminate the facility and all transactions thereunder; and/or
- Liquidate the underlying assets in order to pay itself the Repurchase Price and all obligations owed to the Buyer

Further, under section 362(b) of the Bankruptcy Code, the exercise of certain offset rights are protected by specifically exempting them from the automatic stay that otherwise descends over the Seller. And under section 546(e) of the Bankruptcy Code, certain transfers that have already been made are protected from avoidance. All of these rights may be exercised without having to go through the bankruptcy courts and bankruptcy process, and as a result allowing the Buyer to have almost immediate access to the assets.

WHAT ARE THE PRACTICAL BENEFITS OF A REPURCHASE AGREEMENT?

If properly structured, Repurchase Agreements offer advantages to both Buyers and Sellers including:

- Favorable interest rates due to the lower risk profile to Buyer as a result of the safe harbor protections
- Treatment as debt for tax purposes (while concurrently being treated as a sale under the Bankruptcy Code)
- Buyer protections from the automatic stay of the Bankruptcy Code (as discussed above with regard to legal benefits), enforceability of ipso facto default provisions and protections from avoidance of prior transfers
- Relatively quick timing and process to add and remove assets (for revolving repurchase facilities)
- Repurchase facilities can be set up as a static facility designed for specific assets or as a revolving facility designed for assets to be added and removed over time, as a short-term bridge facility, or a long-term semi-permanent financing solution

WHAT ARE SOME PROVISIONS OF REPURCHASE AGREEMENTS THAT PARTIES SHOULD BE AWARE OF?

- Margin provisions are almost universally included, which can operate to test the amount advanced against a particular asset, against the entire portfolio of assets or against a subset of assets:
  - Margin mechanics are often based on the "market value" of the assets. Market value determinations vary significantly from one transaction to the next, and can be based on appraised value of the underlying real estate, the principal amount of the underlying mortgage loan, the acquisition price of the underlying mortgage loan or, commonly, the "market value" as determined by the Buyer (often based on what Buyer itself determines the market value to be in its sole or reasonable discretion). This latter Buyer determination element can give the Buyer wide discretion on the asset's value and, as a result, the amount of any margin payment that Buyer may require from the Seller.
  - Sellers can negotiate for minimum margin thresholds (e.g., the margin amount being called by Buyer must equal a certain amount before the Seller is required to make payment), two step margin call mechanics (where a "credit event"[2] must first occur before the market value can be assessed and the potential existence of a margin deficit determined)
- Concentration limits can be used to ensure that the facility is not overconcentrated in any one type of metric, whether based on asset class, geographic location, financial metrics or any other characteristic of an asset or pool of assets that a Buyer may determine. If a concentration limit is breached, Seller can be required to reduce the purchase price on the overconcentrated assets or repurchase such assets to address the issue
- Asset level financial tests, for example:
  - Loan-to-value tests based on (i) the amount of the underlying loan or (ii) the purchase price for the asset under the repurchase facility
  - Minimum debt yield tests[3]

ARE THERE WAYS TO INCLUDE OTHER REAL ESTATE DEBT ASSETS THAT MAY NOT QUALIFY?

Invariably there will be a situation where it may be unclear whether a specific type of asset is a qualifying asset for the safe harbors. For instance, while it's clear that a mortgage loan is a qualifying asset, often commercial mortgage transactions are bifurcated into being documented partly as a mortgage loan and partly as a mezzanine loan. A mezzanine loan is, by its nature, not a mortgage loan but instead a loan collateralized by equity interests in the owner of the underlying property. So there remains some doubt as to how a bankruptcy court would treat that mezzanine loan in the context of the safe harbors. This uncertainty can be addressed by taking advantage of the parallel structures that enjoy safe harbor treatment as a result of being related to or connected to a qualifying repurchase agreement, such as pledges, security agreements and credit enhancement arrangements.

Ultimately, Repurchase Agreements are a flexible and dynamic financing tool that have unique advantages to both counterparties over alternative structures. They function well as both a standalone financing facility and as part of a more complex multi-faceted structure and present an extremely attractive choice for financing qualifying assets.

ABOUT KING & SPALDING

Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 1,100 lawyers in 21 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality, and dedication to understanding the business and culture of its clients.

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[1] Special purpose vehicles (also known as an “SPV” or “SPE”) are entities that serve a single purpose (in this case to be the Seller) and are highly restricted in what they are allowed to do and what debt they can incur. Often an independent director is required to vote on any insolvency-related matters. This type of structure allows for assets to be segregated and decreases the likelihood that the entity will enter bankruptcy and, if it does, make it more likely that the Buyer or the lender is the only creditor.
[2] Some common credit events are a default in the underlying mortgage loan, the purchased asset no longer qualifying as eligible under the repurchase facility or an insolvency event occurring with respect to the underlying borrower.
[3] Debt yield tests under a Repurchase Agreement can be measured on an asset-by-asset basis or a portfolio or sub-portfolio basis. On a single asset basis, the test is designed to reveal to a repo Buyer the annual net cash flow of the underlying property as a percentage of the amount of purchase price that the repo Buyer has advanced against the asset collateralized by that underlying property. For a portfolio debt-yield test, the test is conceptually the same, but measures the annual net cash flow from a series of underlying properties against the amount of purchase price that the repo Buyer has advanced against the assets collateralized by those underlying properties.