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The servicer in legal documentation in a typical specialty finance transaction

Funders in the specialty finance sector lend into finance companies or groups of finance companies which themselves make loans available (whether on a secured or unsecured basis) to companies, partnerships, sole traders and individual consumers.

The funders' primary recourse in terms of their security package is to the rights of the finance companies to the underlying loan receivables and any underlying security granted in respect of the same. The role of the company which services and collects the receivables (the "**Servicer**") is therefore of paramount importance from the funders' perspective because those receivables constitute, pre-enforcement at least, the source of repayment of the funders' debt.

This briefing note provides an overview of the remit of the Servicer, explores how and why funders take different approaches to transaction structuring (considering in particular what the Servicer may or may not offer in terms of security) and looks at how other elements of the role of the Servicer are typically addressed in the funders' financing documentation. We have assumed that the Servicer will be a company within the overall group of the finance company, not a third party servicer.

ROLE OF THE SERVICER

The Servicer plays an integral role in the maintenance of loan portfolios (whether the underlying asset performance is positive or otherwise), its remit typically including (i) the establishment of accounts and maintenance of records relating to the underlying loans, (ii) the collection of and accounting for payments in respect of the loans (in accordance with the group's collections policy), (iii) the making of provisions in accordance with the group's provisioning policy, (iv) the taking of steps to utilise and/or preserve the group's rights of remedy in the case of defaulted loans and (v) ultimately the taking of enforcement action against defaulting customers where appropriate to do so – all the while being mindful of the regulatory landscape in which the group operates and satisfying its obligations to treat its customers fairly (for example, considering forbearance where a customer is struggling to make its loan payments).

When structuring transactions from a legal perspective, a funder will look to manage its risk accordingly, taking into account the maturity and sector of the group into which it is funding, and the Servicer's role in maintaining the loan portfolio – in particular, its collection of underlying loan payments – will have a bearing on the legal documentation.

TYPICAL STRUCTURE

The structure we see most commonly in the specialty finance sector (visualised in the diagram below and often described as an SPV structure) comprises:

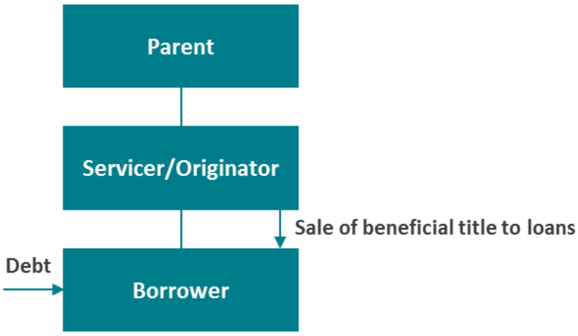
- the beneficial title to loans against which funders will make available debt (at a specified advance rate, which reduces as asset performance deteriorates) being originated by an originating entity (quite often one and the same as the Servicer if the servicing role is held within the relevant group and not outsourced to a third party, though that function may be split out and performed by another vehicle) and sold to the borrower of the funders' debt (the "**Borrower**"), itself typically a wholly-owned subsidiary (or sometimes sister company) of the Servicer;

- the Servicer (on behalf of the Borrower) collecting interest and principal payments and other amounts due from customers of the loans into its own collections account;

- a monthly cash waterfall – which regulates and prioritises payments to finance parties and other fundamental costs and expenses before (in the absence of a continuing event of default) surplus collections are returned to the Borrower – being run from the Borrower's collections account, necessitating a sweep, at some stage, from the Servicer's collections account;

- (although not always granted) a share charge being granted over the shares held by the Servicer in the Borrower; and

- the Borrower granting an all-assets debenture in favour of the funders. Additional security documents or other credit support (including bespoke transaction documents) may be entered into by the Servicer and a consideration of the same is explored later in this briefing note.



A less common (but still fundable) structure might see just one entity taking on the originating and servicing responsibilities and borrowing obligations under the financing (which is typically referred to as an operating company structure), but there are various reasons why an SPV structure (which, for illustrative purposes for the remainder of this briefing note, we have assumed is adopted on the basis of the above diagram) may be preferable for both funders as well as finance companies. These include:

- along with the legal title to the underlying loans, the Servicer (as originating entity) typically holds the regulatory and other authorisations necessary for the operation of the group in its particular sector. It also typically enters into the service contracts with the group's employees. This is the neatest position for funders as the key assets are isolated in one vehicle which (i) can be utilised to structurally subordinate non-senior debt (given this will, other than in the case of mezzanine debt which is usually borrowed by the same entity as the senior debt, typically be injected into the Servicer and on-lent into the Borrower to fund the non-senior advance rate portion of the loans) and (ii) can be taken "clean" (i.e. without any other competing claims) on enforcement. Depending on the exact nature of the security package, funders will be able to re-unite the legal and beneficial titles to the loans through enforcement and, subject to obtaining the necessary authorisations (some or all of which they may already have), are able to become the creditor in respect of the loans;

- if the funders enforce their security over the Servicer's shares in the Borrower (in the process appointing either the standby servicer (if in situ) or their preferred servicer to service the relevant portfolio), the Servicer may remain part of the group which may help to retain value, depending of course on the funders' wider recourse to the Servicer under the financing. This can help to reduce the impact of enforcement on other financings within the group;
- as explored further below, the group may be able to attract and implement different funding lines in respect of the different loan products it offers (the intercreditor analysis in respect of security and guarantee packages becoming more complicated in the absence of a properly split out structure); and
- though beyond the remit of this briefing note, there may be some benefit from a risk retention perspective in the Servicer providing a guarantee of the Borrower's obligations under the financing in question.

SECURITY PACKAGE

Where an SPV structure is adopted, finance companies will consider carefully how the security package they offer to funders may impact on the operations of the group and, below, we've taken a look at the alternative approaches we see in the market.

The most restrictive position from the group's perspective sees funders obtaining an all-assets debenture from the Servicer (giving it security over, in particular, the Servicer's collections account and the legal title the Servicer holds to the loan receivables). Depending on the financial strength of the Servicer (and quite often the Servicer will be an entity of commercial substance within a typical structure which, in addition to selling down the beneficial title to certain loans to the Borrower, will originate or service loans which are either retained by it or the beneficial title to which are sold down to another SPV within the wider group), it may also guarantee the Borrower's obligations under the finance documents. As a full obligor – and documented in the facility agreement as a guarantor, rather than by way of a standalone guarantee – the Servicer will be subject to an extensive suite of representations/undertakings/ events of default (some of which are bespoke to specialty finance structures). This effectively means that the Servicer operates solely to originate and then service loans in the specific portfolio: it will often be restricted from establishing subsidiaries into which it can sell the beneficial title to another pool of assets so is not a viable structure for a group which may want to introduce diversified loan products and envisages separate funding lines in respect of the same. Potential funders to those subsidiaries would seek to have released any all-assets security granted to the incumbent funder at Servicer level (because otherwise that incumbent funder would have a prior-ranking secured claim over collections accounts established for the purposes of collecting in payments in respect of the 'new' portfolio).

An alternative to the above is that the Servicer does not grant a debenture but a combination of an assignment of any rights it has to the loan receivables and a declaration of trust in favour of the Borrower in respect of monies due to the Borrower in its collections account or (alternatively) collections account security. Under the debenture, the Borrower will assign to the funders any rights the Servicer has granted to it under the declaration of trust. In the absence of collections account security, the funders will want a frequent (potentially daily) sweep of monies representing collections due to the Borrower from the Servicer's collections account into the Borrower's collections account (over which it has security) to reduce the time period during which such collections are not secured in favour of the funders. If not a full 'obligor', it will typically have the ability to establish and service loan books in other subsidiaries – this structure is attractive in particular to more mature businesses with acquisition/accelerated growth plans beyond the products currently being originated. Incoming funders to other SPVs in the wider group will be much more comfortable funding into this structure (particularly where the Servicer is not providing a guarantee to the funder of the initial SPV) but each of the funders may still want to impose limitations on what the Servicer may do/incur to ensure its day to day servicing operations are not jeopardised.

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OTHER CONSIDERATIONS

Where the Servicer is not providing a guarantee (and not a party to the facility agreement), its role as servicer is documented in a standalone servicing agreement (with representations/undertakings tailored to the specialty finance sector) and it will likely be subject to events of default within the facility agreement given its importance. Depending on the strength of the parties, it may be an immediate event of default under the facility agreement if the Servicer terminates the servicing agreement or breaches any material obligation in it; otherwise the Borrower may have a certain period of time to establish an alternative arrangement.

Costs borne by the Servicer in servicing the loan portfolio will need to be quantified and will typically feature high in the monthly cash waterfall, even where the book has begun amortising or there is a default/event of default under the facility agreement. The Servicer's ability to manage customers, collect in payments and enforce (where necessary to do so) would be jeopardised without funding for the operating costs to do so. The funders will often seek to limit these costs to a specified percentage of the underlying loan portfolio (for example, in an amount in the region of 0.20% of the portfolio for each calendar month) or otherwise introduce a cap on any estimated costs.

Some funders will insist on a standby servicing agreement being put in place. This ensures a standby servicer (which will be a third party entity unrelated to the finance company) maps the Servicer's servicing of the loan portfolio (on a 'hot' (very regular) or a 'cold' (infrequent) basis depending on what the funders require) so it is able to step into the Servicer's role on the occurrence of specified 'termination events' relating to the Servicer usually set out in the servicing agreement itself.

Travers Smith LLP regularly advises major banks, non-bank financial institutions, alternative lenders corporates and private equity houses in the specialty finance sector and has a wealth of experience in reviewing and implementing the legal structures discussed in this briefing.

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