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Impact of COVID-19 Measures on European Asset-Backed Securitisations

While lessons learned from previous crises suggest that well-designed structures are resilient under stressed circumstances, the COVID-19 crisis presents new challenges for European ABS.

Governments across the globe continue to announce measures in an attempt to minimise the toll on human health and economies arising from the COVID-19 pandemic. Measures include forbearance schemes including payment deferrals to prevent large-scale defaults by consumers, small and medium enterprises (SMEs), and in some cases, larger corporates. In addition, borrowers and lessees are requesting forbearance irrespective of whether such requests are backed by state measures.

Lessons learned from the financial crisis of 2008 and the Eurozone sovereign debt crisis suggest that well-designed asset-backed securitisations (ABS) are resilient under stressed circumstances. While the facts differ in some respects from previous crises, many issues remain the same. Structural features such as overcollateralisation, note subordination, liquidity facilities, and cash reserves have previously demonstrated their effectiveness in managing cash flow disruptions, especially with widely placed "public" transactions.

However, the COVID-19 pandemic presents novel challenges not seen in previous crises. A key issue for private ABS structures (particularly for private loan-on-loan transactions) is the impact of forbearance on the amortisation of underlying assets (*e.g.*, consumer loans, equipment leases, and mortgages used as collateral), which can affect the valuation of the borrowing base and calculation of portfolio financial covenants. While forbearance may be a necessary stopgap measure, the resulting frictions on cash flows and characterisation issues with respect to underlying assets may make financing these assets more challenging and as a result, may have longer term repercussions on funding in the real economy.

While structures such as collateralised loan obligations, commercial mortgage-backed securitisations, whole business securitisations, and synthetic risk transfer transactions also face novel COVID-19-related challenges, this *Alert* focusses on questions regarding the effect of the pandemic and related government interventions on ABS transactions.

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Key questions raised regarding ABS transactions

1. What is the impact on cash flows?

As the impact of COVID-19 continues to develop, existing ABS structures in certain sectors are experiencing deterioration of cash flows owing to:

- "Temporary" forbearance schemes implemented by governments in order to prevent widespread defaults
- Forbearance requested/demanded by financially distressed borrowers outside of state-backed measures
- Increased levels of defaults by borrowers and lessees owing to pandemic-related circumstances, *e.g.*, lost income due to social distancing, furloughing, or layoffs
- Sector-specific challenges (*e.g.*, severe limits on travel, hospitality, and retail industries) leading to increased occurrence of default or cessation of business
- Operational challenges, *e.g.*, servicers, trustees, and agents experiencing lack of key personnel or limited access to premises

On 17 April 2020, the Financial Conduct Authority (FCA) proposed a package of forbearance, benefitting UK consumers under motor finance and high cost credit agreements (*e.g.*, payday loans and rent-to-own agreements), for consumers impacted financially by the pandemic.[1] The FCA's proposals are in addition to a previously implemented three-month period of forbearance for consumer credit cards and personal loans when requested by borrowers. The FCA issued guidance in March 2020 expecting mortgage lenders and administrators to grant forbearance for up to three monthly payments under regulated mortgage contracts when requested by homeowners experiencing pandemic-related financial difficulty. In addition, the UK Government came to an arrangement with UK lenders to accommodate forbearance requests by buy-to-let (BTL) landlords whose tenants had lost income due to the pandemic (since 26 March 2020, landlords have been required to wait at least three months before initiating eviction proceedings for non-payment of rent for private or social accommodation).

The shutdown of certain sectors of the economy has affected some SMEs and larger businesses and their ability to perform their contractual obligations. For example, SMEs subject to lockdown restrictions need forbearance for payment obligations under leasing contracts (*e.g.*, for equipment) until they are able to resume trading. While investors in ABS backed by receivables under leasing contracts will bear the brunt of such forbearance, structures backed by large granular pools of assets should be able to absorb a certain amount of losses.

Whether arising directly from forbearance or from the consequences of the pandemic more generally, there is a real issue for directors of companies in relation to the potential "wrongful trading" consequences of continuing to trade in the light of concerns about their ability to meet their payment obligations. In response to a growing chorus advocating for a legislative fix, countries such as the UK are implementing temporary "safe harbours" from wrongful trading liability. On 29 March 2020 the Government announced it would bring forward legislation to introduce a temporary suspension of wrongful trading provisions (applied retroactively from 1 March 2020) to mitigate directors' risk of personal liability during the pandemic.

2. How are underlying assets affected?

While public transactions may have sufficient cash reserves built into the transaction structure to mitigate the effects of a reduction of cash flows in the medium term, as the pandemic continues many structures are eating through their cash reserves and a number of public ABS tranches have been downgraded or put on negative watch as a result. Private ABS structures, which are often structured as "borrowing base" facilities, are particularly vulnerable. Borrowing base facilities typically include financial covenants based on pre-agreed triggers, which apply to "delinquent" and "defaulted" receivables (generally 30-60 days and 90-120 days past due, respectively) which, if breached, could result in the facility going into early or rapid amortisation or trigger an event of default.

Cash flow disruptions could breach debt service coverage ratios and other performance covenants, which may initially trip amortisation triggers and eventually result in events of default. Failure to satisfy extension conditions due to triggers could mean that a large number of transactions could enter into early amortisation. This would also bring to an end the originator's ability to keep funding new business, and existing asset portfolios would effectively be forced into wind-down.

Similarly, forbearance may result in the value of the "borrowing base" being deemed to be reduced if the transaction documents treat such forbearance as delinquency. A reduction in the borrowing base would typically also require a repayment of principal to be made to bring the borrowing base into compliance with the pre-agreed loan-to-value ratio. There may be insufficient cash in the structure to make that repayment which, in turn, may result in the transaction falling into early amortisation or default. Failure to satisfy extension conditions due to triggers could mean that a large number of transactions could enter into early amortisation. Any consequential events of default could trigger partial swap breakages for interest rate hedges where the notional amount is set out in a schedule based on an expected profile of origination for new assets (rather than being a balance guaranteed swap).

The analysis depends on whether forbearance-affected assets are characterised as in arrears, non-performing, or merely subject to suspended obligations such that the receivable was not due or payable in the first place. At the beginning of April 2020, the European Banking Authority (EBA) published detailed guidance (the EBA Guidance) regarding the regulatory treatment of assets subject to or eligible for temporary COVID-19-related forbearance. The EBA Guidance acknowledges that forbearance is implemented differently in Member States, with schemes ranging from informal agreements between lenders and competent authorities to strong regulatory guidance and legislated mandatory rules. In an attempt to regularise the approach across Member States and provide guidance to Member States as to how, in the view of the EBA, the Capital Requirement Regulations (the CRR)[2] should be interpreted in this respect the EBA Guidance states that in order to avoid triggering a forbearance classification in a lender's systems, the forbearance measure must:

- Be in response to the COVID-19 pandemic and not used for new lending during the outbreak
- Apply broadly to financial institutions in a given jurisdiction in respect of a broad range of obligors (*e.g.*, borrower type, sector, size) irrespective of creditworthiness
- Offer the same conditions to all obligors subject to the forbearance measure
- Change only the schedule of payments, not other conditions of the loan (*e.g.*, interest rates)

The FCA's approach is broadly consistent with the EBA Guidance, stating that customer's accounts should not be recorded in lenders' systems as being in detrimental arrears if COVID-19 forbearance is

granted, in order to ensure that the customer's credit rating is unaffected. However, the EBA Guidance and FCA statement provide only an interpretation of the CRR, which applies only to credit institutions and investment firms that fall within scope of the CRR. Notably, notwithstanding such official guidance, forbearance-affected assets may still be caught by the definitions of delinquent or defaulted assets in the transaction documentation. Lenders are taking different approaches to the contractual position, depending on the:

- Type and jurisdiction of the lender (*e.g.*, banks vs. private equity)
- Transaction structure (*e.g.*, public vs. private ABS vs. warehouse facilities)
- Underlying asset class
- Strength of the relationship with the borrower

As it stands, the regulatory approach to asset characterisation merely delays the impacts mentioned above. As pandemic-related developments continue, affected borrowers may experience financial difficulties beyond the three-month forbearance period. If borrowers struggle to catch up on deferred payments at the end of the forbearance period, then loans will be re-characterised as in arrears. The build-up of added debt will put even greater pressure on borrowers in the post-forbearance period.

There are different ways of seeking to address within existing transactions the implications of regulatory forbearance and informal forbearance requested or demanded by borrowers experiencing financial difficulties. One could amend the documentation to allow for pandemic-related forbearance on a temporary basis such that the assets do not fall within the permitted delinquency/default buckets and do not trip the debt service coverage ratio and other performance triggers. Alternatively, amortisation of debt could be temporarily changed to a more sequential basis of amortisation and/or additional cash reserves could be built up. Some of the cash that would otherwise be used to finance new origination or repay pro rata senior and junior debt could be diverted on a temporary basis to de-lever the transaction on a sequential basis and replenish cash reserves.

Obtaining investor consent is typically more straightforward for private transactions, which do not have the same need for the formal noteholder consent processes required under public ABS structures. Interests may also be more aligned in a private ABS context — it makes sense from a commercial and reputational perspective to avoid cutting off a valuable source of funding for originators. While lenders are checking transaction documentation closely, many are currently adopting a "wait and see" approach to portfolio trigger and/or borrowing base breaches. In any event, the approach taken will be fact-dependent. Investors may be less likely to give consent if "catch-up" payments extend the loan's maturity or are amortised during the life of the loan (as opposed to immediately following the forbearance period). There may also be less appetite to accommodate forbearance if government schemes are subsequently widened in scope or impose ever longer forbearance periods such that the economics of the transaction change fundamentally.

3. What are the effects on servicing?

Servicers should consider what effect (if any) forbearance will have on the servicer's duty/standard in carrying out its servicing obligations, for example by asking what maximising recoveries/prudent behaviour means in each context. The pandemic presents its own unique set of facts, and its effect on servicing standards will differ in countries where forbearance is mandatory, imposed by "strong guidance", or arranged voluntarily by lenders.

The first question is whether the particular forbearance measure fits within approved servicing and collection policies set out in the relevant servicing agreement. On the borrower-friendly end of the spectrum, servicing standards might allow forbearance, provided that they are undertaken in accordance with a prescribed standard of care and the approved collections policy. At the most lender-friendly end of the spectrum, such relief may be prohibited altogether. In between the two positions, forbearance could be subject to overall pool concentration limits, or banned if it changes the principal amount outstanding or maturity date of the asset. In some instances servicing standards may also grant the discretion to grant forbearance, provided that either of the following are true:

- Doing so does not prevent the asset from being included in the permitted delinquency/default buckets for the purposes of the portfolio covenants
- The originator repurchases the affected asset

Servicers may find themselves in a position where, technically, they are contractually bound not to offer forbearance at the same time as such forbearance is required by law as a result of the government intervention. While most transactions will generally allow for the servicer to do/refrain from doing something if required by law, this could put them in a difficult position. Servicing standards typically require servicers to service the underlying portfolio as they would their own book or any other book they are servicing, i.e., introducing a market standard element, which may be beneficial to servicers defending their actions in permitting forbearance (or not), depending on market trends.

Forbearance can have unintended consequences for servicing arrangements more generally, especially if an early amortisation or an event of default triggers a servicer termination event. If a borrowing base facility's financial covenants are breached as a result of such measures, the lender may be permitted to replace the servicer (normally the original servicer is the originator or a member of its group, and is entitled to a servicing fee). However, if servicers are applying collection policies consistently with market practice, then the breaching of triggers is unlikely to be considered a servicer performance issue.

If the original servicer (who is typically in the same group as the originator) runs into financial difficulties, ABS investors will want to keep an eye on what alternative servicing is necessary and available. Even where a back-up servicer is contemplated in the transaction documents, it will take time for the back-up servicer to assume normal servicing duties.

4. What is the impact on other transaction counterparties?

Banks in Europe are significantly better capitalised than they were during the financial crisis, and the financial system as a whole is much better placed to weather the storm. However, as the sharp economic contraction resulting from the pandemic crisis continues, there will be increasing downward pressure on credit ratings in the financial services sector generally. In public rated securitisations, credit rating agencies typically require that transaction documentation include "downgrade triggers" regarding counterparties such as account banks, liquidity facility providers, and hedge counterparties in order to mitigate points of credit risk along the chain of cash flows.

In the event of an account bank downgrade below a predetermined threshold, the account bank typically would be required to find a replacement and exit the transaction. Similar provisions usually apply to paying agents and cash managers. When a liquidity facility provider is downgraded below a certain level, the expectation is that the issuer would draw down the entire commitment of the liquidity facility and deposit the amount into a standby drawdown account. This feature ensures that liquidity remains

available to smooth out temporary disruptions to revenues from the underlying assets, which is doubly important under a stressed scenario.

During the financial crisis, a number of transactions were kept in limbo where counterparties were downgraded and needed replacing at a time when other similar entities were in the same position, making it difficult, time consuming and/or expensive to appoint a replacement. In addition, trustees were reluctant to step in without noteholder instruction, which can take valuable time when the notes are widely held through the clearing systems. Failure to appoint a sufficiently rated counterparty in good time may result in the securitisation tranches being downgraded, which can then trigger a sell off by investment vehicles and funds with minimum rating requirements in their investment criteria (with ramifications on liquidity and pricing).

Following the financial crisis, transaction documents were improved to allow for smoother transition between counterparties. For example, post-financial crisis transaction documentation typically includes the following features:

- The incumbent counterparty remains until a replacement is appointed
- Trustees are indemnified and pre-funded, and are therefore able to appoint a replacement (rather than rely on the outgoing counterparty to find its own replacement)
- Trustees are able to rely on “negative consent” from noteholders (*i.e.*, deemed consent in the absence of an objection within a certain period of time) rather than require noteholder instructions to act, which improves the timeframe for confirming the appointment of a replacement

Credit support arrangements accompanying interest, basis rate, and currency hedging (among others) typically adopt a stepped approach to replacing a hedge provider. Upon a downgrade within a certain threshold, the hedge provider typically delivers collateral to the issuer, which is placed in a reserve account. If the hedge provider is downgraded below a further prescribed rating threshold, only then must it be replaced. If the hedge provider is the defaulted (or affected) party, payments owed by the issuer to the hedge provider are subordinated vis a vis the rated notes. This tiered approach is helpful in distressed conditions where other hedging providers experience downward pressure on their credit ratings at the same time — meaning that the availability (and pricing) of a replacement may not be straightforward.

5. Are English law payment obligations subject to another country’s forbearance still enforceable?

A conflict arises when one party to an English law-governed contract must make a payment according to English law, but the laws of another jurisdiction require the other party to extend forbearance. Will non-payment in this scenario cause a default under English law? The answer is: “it depends”.

The general rule of the Rome I Regulation on the choice of law of contracts (Rome I)[3] is that the manner in which a contract must be performed will be governed by the law chosen by the parties (subject to some exceptions).[4] Rome I applies to the choice of governing law of any state, not just the laws of Member States; therefore no reciprocal agreement is necessary with third countries. From 31 December 2020 the “onshored” version of Rome I will apply in the UK in the same way, *i.e.* regarding the choice of law of any foreign law.

Article 6(2) of Rome I permits the parties to a consumer contract (*e.g.*, credit cards, retail auto loans, and consumer loans) to choose the governing law of the contract, provided that such choice does not deprive

the consumer of protections that would have applied, in the absence of such choice, under the laws of the country in which the consumer habitually resides. COVID-19 forbearance measures are clearly intended to protect consumers and should therefore overrule a payment obligation in an English law consumer contract. However, the definition of "consumer" under Rome I is limited to natural persons acting outside of their trades or professions — Article 6(2) does not apply to wider forbearance measures that apply to SMEs, larger companies, or individuals acting in the course of their trades or professions.

More widely, in certain scenarios the law of a country other than that chosen in the contract should be taken into account when a country applies overriding mandatory provisions in order to safeguard its public interests, such as its political, social, or economic organisation, irrespective of the law otherwise applicable to the contract.[5] Pandemic-related measures are clearly intended to safeguard public interests if they are aimed at protecting the economy and financial system during a temporary shutdown of business activity to combat the spread of COVID-19. Article 9(3) of Rome I allows effect to be given to overriding mandatory provisions of the law of the country where a contract is to be performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful. Application of Article 9(3) will depend on how the COVID-19 measures are implemented. There is a strong argument that, for example, French forbearance measures for SMEs in France would override an English law payment obligation. In contrast, forbearance arising in the UK by virtue of the FCA's "strong guidance" may not override a contract, because the FCA's guidance does not make payments under the contract unlawful, provided that the lender finds it in the borrower's best interests to find alternative arrangements. The applicability of Articles 6(2) and/or 9(3) could help determine whether a debt obligation has been discharged, suspended, or breached — which has consequences for ABS investors, originators, servicers, and underlying borrowers.

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Endnotes

[1] FCA press release of 9 April 2020.

[2] Regulation (EU) No 575/2013.

[3] Regulation (EC) No 593/2008.

[4] Article 3(1), Rome I.

[5] Article 9(1), Rome I.