EFFECTS OF THE COVID-19 CRISIS ON EUROPEAN SECURITISATION TRANSACTIONS

The COVID-19 crisis has some specific implications for securitisations both in terms of the impact on existing transactions and the regulatory disclosure obligations on securitisation participants in the EU. In addition, regulatory authorities have sought to clarify the extent to which forbearance measures with clear application to banking transactions might also extend to securitisations. We summarise these issues in this client alert.

COVID-19 and "Significant Event" Disclosure Under the Securitisation Regulation

Background

Under Regulation (EU) 2017/2402 (the "**Securitisation Regulation**") certain "significant events" are required to be disclosed by the originator, sponsor and securitisation special purpose entity ("**SSPE**") of a securitisation[1]. In particular, Article 7(1)(g) of the Securitisation Regulation requires the originator, sponsor and SSPE to disclose to holders of a securitisation position, to the applicable competent authorities and to potential investors the occurrence of events such as:

- a material breach of the obligations of the parties to the transaction documents, including any remedy, waiver or consent subsequently provided in relation to such a breach;
- a change in the structural features that can materially impact the performance of the securitisation;
- a change in the risk characteristics of the securitisation or of the underlying exposures that can materially impact the performance of the securitisation;
- in the case of STS securitisations, where the securitisation ceases to meet the STS requirements or where competent authorities have taken remedial or administrative actions[2]; and
- any material amendment to transaction documents.

The lead-in to Article 7(1)(g) makes it clear that the events above are indicative do not comprise an exhaustive list of all of "significant events".

Given the current crisis, what "significant events" should be disclosed?

The *effects* of the COVID-19 crisis on securitisation structures, rather than the existence of the

[1] In practice this obligation will fall on one of the originator, sponsor or SSPE, given that Article 7 of the Securitisation Regulation requires such entities to designate amongst themselves a single entity to fulfil the information requirements of Article 7.

[2] Chapter 4 of the Securitisation Regulation provides a framework for "simple, transparent and standardised" or "STS" securitisations, which can result in more favourable regulatory capital treatment for qualifying securitisation exposures.

COVID-19 crisis itself, are key to an analysis as to whether a significant event has occurred with respect to a particular securitisation transaction. The European Securities and Markets Authority ("**ESMA**") has provided further technical standards on disclosure requirements[3], stating that any event that would be likely to materially impact the performance of the securitisation as well as having a significant effect on the prices of the tranches/bonds of the securitisation, should be considered to be a significant event.

The COVID-19 crisis has had - or is anticipated to have - a broad range of effects on securitisation transactions, including:

- breaches of financial covenants that benchmark the proportion of defaulted or delinquent (i.e., overdue) securitised receivables to the overall portfolio of securitised receivables;

- the occurrence of stop purchase events (where the transaction transitions from revolving period to scheduled amortisation) and events of default (following which a lender may demand the acceleration of the financing and where the transaction security can be enforced), particularly where portfolio triggers are breached or, following significant credit stress in the case of businesses that are particularly exposed to the economic effects of the COVID-19 crisis (for example, the aviation, retail and hospitality sectors), in the event of insolvency events and credit downgrade triggers; and

- the introduction of amendments to transaction documentation permitting temporary forbearance with respect to underlying securitised assets or the introduction of additional liquidity measures and/or credit enhancement, in the context discussed in "Effect of Moratoria on Securitisation Transactions", below.

Each such effect needs to be examined and determined to be significant - and this will vary depending on the transaction. In the case of a public securitisation[4], perhaps the most useful standalone benchmark to be used in determining whether a significant event has taken place will be whether the event has a significant effect on the prices of the securitisation bonds. It should be clear however that the EBA test of a significant event being any event likely to materially impact the performance of the securitisation, is particularly broad. In any event it is likely that, given the potential penalties for failure to disclose[5], originators and lenders will want to take a relatively conservative approach in determining whether the significant event threshold is met in a particular set of circumstances, and notify such COVID-19 originated effects.

When to disclose

The Securitisation Regulation states that the occurrence of a significant event shall be made available "without delay", and should not be dependent on (i.e., linked to) the frequency of the existing transaction reporting under Article 7[6]. In the context of public securitisations, this disclosure should be made available by means of a securitisation depository or, until such time

[3] The revised draft technical standards on disclosure requirements under the Securitisation Regulation, 31 January 2019.

[4] A "public securitisation" is a securitisation where a prospectus has to be drawn up in compliance with Directive 2003/71/EC or Regulation (EU) 2018/1129, as applicable.

[5] Including fines for non-compliance due to negligence or wilful breach.

[6] There is no real clarity as to what "without delay" should mean with respect to significant event disclosure. However a reasonable conclusion is that disclosure should be made as soon as the relevant event is known to have occurred, rather than postponing disclosure until the next transaction reporting date.

as a securitisation repository is registered with ESMA, by means of a website that complies with the requirements set out in Article 7(2) of the Securitisation Regulation[7]. For private securitisations, the significant event information must be provided to the holders of a securitisation position in the relevant transaction, and should be provided similarly "without delay" following the occurrence of the significant event.

Guidelines on Legislative and Non-Legislative Moratoria

On 2 April 2020, the European Banking Authority ("**EBA**") issued Guidelines on legislative and non-legislative moratoria on loan repayments in light of COVID-19[8] (the "**EBA Guidelines**"). On 22 April 2020, the EBA issued a clarification by way of a supplementary supervisory statement explaining how the EBA Guidelines apply to securitisations[9] (the "**EBA Statement**").

Background

The EBA Guidelines have been issued in response to the fact that as a consequence of the COVID-19 crisis, many EU Member States have implemented a broad range of support measures to businesses, including moratoria on payments of credit obligations[10]. These support measures have tended to be, both in conception and application, national responses and remain quite diverse. For example, some Member States have introduced jurisdiction-wide moratoria based on specific legislation, whereas in many others moratoria have been implemented through voluntary industry-wide or individual initiatives by institutions.

In the opinion of the EBA, this "raises questions of the legal effect such measures have on the current prudential framework, especially in the context of the application of the definition of default and classification of forbearance".

Existing capital adequacy rules under the CRR[11] require that banks in the EU[12] maintain a continuously sufficient amount of own funds[13] available to absorb any losses. Specifically, the CRR requires that, in the determination of the required ratio of own funds, some of a bank's outstanding positions must be deducted from that calculation including the applicable amount of insufficient coverage for certain non-performing exposures. Non-performing exposures include, *inter alia*, certain deductions and forbearance[14]. The EBA Guidelines clarify that, provided a moratorium meets certain prescribed criteria[15], it will be considered to be a "general

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[7] The website (a) includes a well-functioning data quality control system; (b) is subject to appropriate governance standards and to maintenance and operation of an adequate organisational structure that ensures the continuity and orderly functioning of the website; (c) is subject to appropriate systems, controls and procedures that identify all relevant sources of operational risk; (d) includes systems that ensure the protection and integrity of the information received and the prompt recording of the information; and (e) makes it possible to keep record of the information for at least five years after the maturity date of the securitisation.

[8] EBA/GL/2020/2, 2 April 2022.

[9] On 18 June 2020, the EBA clarified that, in light of the fact that the economies of many EU member states remained unopened as a consequence of the COVID-19 crisis, the EBA Guidelines would apply until 30 September 2020.

[10] A common element of such measures is that they provide for payment relief for obligors affected by the COVID-19 pandemic by allowing suspension or postponement of payments within a specified period of time (often 3 months), allowing the obligors to return to regular payments after the situation is back to normal.

[11] Regulation (EU) No. 575/2013, most recently amended by Regulation (EU) 2019/876.

[12] And, until 31 December 2020, banks in the United Kingdom.

[13] Most importantly, Common Equity Tier 1 capital.

[14] Article 47(a), CRR.

[15] These include the following: (i) the moratorium was launched in response to the COVID-19 pandemic and is applied before 30 September 2020; (ii) the moratorium is broadly applied and is not be limited only to those

payment moratorium" (a "**GPM**") and will not in itself lead to a reclassification under the definition of forbearance for the purposes of the CRR. In other words, where a borrower's payment obligations are restructured or "forborne" - which would in normal circumstances qualify as a forbearance measure or distressed restructuring for the purposes of the CRR - a credit institution will not be required to add any additional capital to meet the required own funds threshold/ratio applicable to it.

The EBA Statement - what it says about "forbearance" under the EBA Guidelines, as applied to securitisation

The EBA Statement explains that the EBA Guidelines apply in relation to "all of the exposures of an institution within the scope of the moratoria". For the purposes of applying the EBA Guidelines to a securitisation, "exposures of an institution" should be read to mean:

- *in traditional securitisations*, any underlying exposures which remain *on the originator institution's balance sheet* in accordance with the applicable accounting standards or which the originator institution has not excluded from its calculation of risk-weighted exposure amounts and, where relevant, expected loss amounts, in accordance with Article 244 of the CRR (recognition of significant risk transfer); and

- in *synthetic securitisations*, any underlying exposure where the transfer of risk to third parties is achieved through credit derivatives or guarantees, and the exposure being securitised remains on the originator institution's balance sheet, notwithstanding its treatment for the calculation of risk-weighted exposure amounts.

With respect to this clarification, the following observations may be made:

- if securitised assets remain on *balance sheet*, a GPM imposed on the exposures of an originator that includes the exposures represented by those securitised assets should mean that in respect of those securitised assets, the existence of the GPM will not automatically lead to their reclassification as being securitised exposures in default or in forbearance for the purposes of the CRR; and

- the EBA Statement makes it clear that institutions should continue to assess the potential unlikeliness to pay of obligors subject to a GPM (including, in particular, as regards the impact on the pool's expected and unexpected losses), as required by the EBA Guidance[16].

The EBA Statement and "implicit support" in the event of a payment moratorium

While many securitisations incorporate credit enhancement features such as liquidity reserves and overcollateralization, sponsors and originators often wish (or feel commercial pressure) to provide support to a securitisation in difficult times where, for example, securitisation assets do not perform as expected.

In cases where a securitisation achieves off balance sheet treatment - "significant risk transfer"[17] for the purposes of the CRR with the result that an originator is able to exclude the

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obligors who experienced financial difficulties before the outbreak of COVID-19 pandemic; (iii) the moratorium changes only the schedule of payments, i.e., it suspends, postpones or reduces payments (principal, interest or both) within a limited period of time; and (iv) the moratorium does not apply to new loan contracts entered into after the date the moratorium was announced.

[16] See paragraph 14, EBA Guidance.

[17] Per Article 247(1) of the CRR which states that "where an originator institution has transferred significant credit risk associated with the underlying exposures of the securitisation… that institution may…in the case of a

securitised exposures from its calculation of risk-weighted exposure amounts - Article 250 of the CRR precludes a sponsor or originator of a securitisation from providing support, directly or indirectly, to the securitisation beyond its contractual obligations with a view to reducing potential or actual losses to investors. Under the terms of the CRR, the provision of implicit support in such cases risks bringing securitised assets back on balance sheet[18].

The EBA Statement indicates that the suspension, postponement or reduction of payments due under securitised assets pursuant to a GPM (legislative or non-legislative) will not be automatically regarded as prohibited implicit support under Article 250 of the CRR. This position is justified by the EBA Statement on the following grounds:

- where those actions are taken under a legislative moratorium, they represent compliance with a legal obligation, hence they cannot be considered as a breach of the prohibition of implicit support laid out in Article 250 of the CRR; and

- the purpose of any such action of suspension, postponement or reduction of payments is not aimed at reducing the actual or potential losses to investors from the securitised assets. Rather, its purpose is to comply with the applicable GPM, legislative or non-legislative which, in turn, addresses the set of exceptional public health, economic and market circumstances triggered by the surge and spread of COVID 19 in the EU and the rest of the world.

In addition, the EBA Statement highlights certain additional circumstances that will not automatically be judged to be implicit support involving the originator, sponsor institutions or the servicer, such as a restructuring or amendments to the contractual documentation governing the securitised assets as appropriate or necessary to implement or comply with a GPM. The EBA Statement even goes so far as to propose that the provision of upfront liquidity or other form of financial support to the securitisation by an originator or sponsor institution or the servicer on a temporary basis and to address any shortfall in the securitisation that may occur as a result of a general payment moratorium should be permissible, provided that the repayment of the liquidity facility or applicable financial support is given the highest seniority in the securitisation priority of payments.

Effect of Moratoria on Securitisation Transactions

It is clear that transaction participants will need to look closely at the effects that any forbearance action may have on existing securitisation documentation[19]. There are several likely effects, which we highlight below.

Servicing

The EBA Statement acknowledges that, as a consequence of the EBA Guidelines, servicers would in the case of legislative moratoria, be obliged to defer the collection of payments for in-

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traditional securitisation, exclude the underlying exposures from its calculation of risk-weighted exposure amounts, and, as relevant, expected loss amounts".

[18] The expressed intention of the implicit support rule is to "maintain the integrity, permanence and soundness of the capital relief granted to an originator at the inception of the transaction", and to ensure that, where the originator has transferred to the investors a significant amount of risk embedded in the securitised exposures, "it must treat the securitisation on an arm's length basis…and may not seek to re-expose itself to the transferred risk as a means of subsidising or indemnifying the investors."

[19] The EBA Statement makes it clear that the regulatory capital treatment on the securitised exposures under the EBA Guidelines should be understood [to be] "without prejudice to the application to the securitisation positions of any definition of event of default, acceleration event, credit restructuring events or similar definition in connection with a general payment moratorium under the contractual documentation governing the securitisation."

scope assets until the end of the moratorium period without triggering an event of default under those assets and in the case of non-legislative moratoria, may likewise defer the collection of payments, in accordance with the applicable scheme. As such, it is particularly important for both originators and lenders to check whether the servicer is able, under the terms of the securitisation documents, to take such actions.

The actions and discretions of a securitisation servicer are typically set out in the servicing agreement, and determinants of a servicer's actions include (a) the operational servicing procedures under which it is agreed that the servicer should perform its functions (sometimes the servicer gives an undertaking that it will perform its servicing functions in accordance with its established operational servicing procedures); and (b) specific contractual undertakings, including to perform its duties as servicer with due care[20].

In light of these obligations, we would make the following observations:

- whether or not the introduction of forbearance measures will be permitted under the transaction documents will usually be determined by the level of flexibility incorporated into the concept (usually a definition) of the servicer's "servicing procedures". For example, in some transactions, reference will simply be made to the existing operational servicing procedures under which a servicer performs its functions and to the extent that those servicing procedures anticipate and permit the introduction of forbearance measures that are mandatorily applied, no changes to the transaction documents themselves may be necessary; whereas in other transactions servicing procedures may be set out in (and sometimes even prescribed) in the transaction documentation, in which case specific amendments might need to be sought by an originator/servicer; and

- it is quite usual that servicers be required to notify or seek consent from investors in connection with material changes to their servicing practices and we anticipate that servicers will notify (and in all probability, enter into dialogue with) their lender/investors

Other effects

Apart from the effects on the servicer's role, forbearance measures may have significant effects on a transaction's cash-flow. As such, we anticipate that transaction participants will conclude that amendments and waivers may need to be implemented in order to waive transaction triggers that would otherwise be impacted by forbearance effects.

We note that the following items are increasingly subject to discussion in securitisation transactions:

- the raised likelihood of seeing breaches of financial covenants that benchmark the proportion of defaulted or delinquent (i.e., overdue) securitised receivables to the overall portfolio of securitised receivables, potentially resulting in stop purchase events (leading to amortisation) or events of default (leading to acceleration of the financing facility);

[20] Often expanded to incorporate the concept of the servicer being required to manage the securitisation assets: (a) in accordance with the standards of a "prudent and informed businessman", and/or (b) to at least the same standard and with the same level of diligence which the servicer applies to the servicing of its own assets.

- related to the above, the implementation of modifications to documentation to permit for pandemic related forbearance on a temporary basis; and
- attempts to modify and improve the credit enhancement of transactions, including the implementation of liquidity reserves, following the EBA Statement's clarifications on "implicit support".

Will the COVID-19 Crisis Trigger a Material Adverse Effect in Transaction Documentation?

As the COVID-19 crisis has developed, there has been fresh focus on whether lenders may consider relying on existing material adverse effect clauses ("**MAE**") in their financing documents, with borrowers concerned as to the vulnerability of existing funding arrangements to MAE triggers where their credit and businesses have not been otherwise affected by the crisis in the short-term. In securitisations, the occurrence of an MAE will often give a lender the option, among other things, to call a stop purchase event, and switch the securitisation into a scheduled amortisation phase.

We have provided analysis on the effect of the COVID-19 crisis on MAE provisions in financing documentation in our alert: Material Adverse Effect Clauses and Covid-19. Our analysis is equally relevant to securitisation transactions, and our primary conclusions are that:

- pursuant to recent case law: (a) external economic or market changes should not of itself constitute an MAE, (b) a lender cannot trigger an MAE clause on the basis of circumstances it knew about at the time of execution of the financing agreement, unless these circumstances have themselves materially changed, (c) determining whether an event or circumstance affecting a borrower/originator is "significant" or "temporary" may be difficult to conclude in practice; and
- there may be considerable reputational risk in calling an MAE in times when, as we have seen, markets and governments tend towards forbearance and financial support to corporates.

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