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CORONAVIRUS: IMPACT ON EUROPEAN RESIDENTIAL MORTGAGE SECURITISATION MARKETS

The coronavirus (COVID-19) pandemic has had immediate wide-ranging effects on the capital markets. Debt and equity capital markets have been impacted by falling prices, high volatility and a lack of certainty. COVID-19 presents a particular set of risks to investors in residential mortgage-backed transactions and – in the light of recent central bank measures – some unique and compelling opportunities as a source of alternative funding.

Aspects of securitisation make residential mortgage securitisation more resilient to market instability than traditional sources of funding, such as unsecured corporate debt and shares. Reliance on income from large pools of consumer assets with a range of obligors make the impact of economic shocks less likely to have a catastrophic impact on a transaction – particularly in securitisations with highly granular retail pools. That said, even very granular, diversified pools of consumer assets can be affected by generalised macro-economic factors. While many assets in a securitised portfolio might be affected in varying degrees by events like COVID-19, the portfolio as a whole will often be large enough that distressed assets do not seriously affect the integrity of the transaction. In periods of market stress, secured financing backed on high quality assets can be more attractive both to investors, where the security and insolvency-remoteness of the transaction insulates creditors from the risk of originator default, and to originators, who can maintain lower funding costs despite market volatility. Originators of residential mortgages may be particularly attracted to securitisation as a method of obtaining low-cost central bank funding by using retained securitisations as eligible collateral.

Residential mortgage cashflows and mortgage payment holidays

Residential mortgage-backed transactions faces a particular set of risks due to the COVID-19 pandemic. The most immediate of these is a lack of short-term liquidity. Securitisation transactions are dependent on regular and predictable payments being made on the securitised assets for income. In the context of RMBS, the transaction is reliant on the collection of scheduled payments of interest and principal from mortgage borrowers. That income is needed to make payments of interest and principal to investors and to pay fees to counterparties.

Securitisation transactions, however, are typically structured to withstand short-term stress on incoming cashflows (and a variety of mechanisms are used to increase liquidity in those instances, such as cash reserves and liquidity facilities). Depending on a range of factors – including the size of the cash reserves and the liquidity facilities and the rates of interest payable on the bonds – these liquidity measures can be very

robust. A recent article by S&P, for example, concluded that "most Italian RMBS transactions that [they] rate have cash reserves or liquidity facilities that would cover at least two years of senior expenses and note coupons at current interest rates, even if cash inflows to the transaction fell to zero"[1]. Not all transactions are quite so robust, though, and a more extended interruption of income or a sustained period of lower than expected income could lead to shortfalls in the amount available to issuers to meet their liabilities, including payments of interest. That said, it would typically require a failure to pay interest on the most senior class of notes in an RMBS transaction before an event of default occurred on the notes.

On 17 March 2020, the Italian government enacted a moratorium on debt payments, including mortgage loans, during the COVID-19 crisis. On 18 March 2020, the Spanish government enacted a moratorium on mortgage loan payments during the COVID-19 crisis. Both moratoria represent mandatory measures to assist those first-home mortgage borrowers in financial difficulty who apply for it. It is not a blanket moratorium on all mortgage payments. On 17 March, the UK government announced a non-mandatory measure by which mortgage lenders had agreed to offer mortgage payment holidays for up to three months. Accordingly, UK mortgage lenders are also waiving late payment fees for customers affected by coronavirus and offering streamlined approval processes, including self-certification.[2]

These measures in Italy, Spain and the UK (and similar measures in any other country that chooses to introduce them) are likely to lead to a lower than expected amount of income in the coming months for mortgage lenders and, consequently, RMBS transactions in those jurisdictions.

Even where these payment holidays don't result in sufficient disruption to cashflows to have a serious effect on bondholders or other senior lenders, residential mortgage securitisation market participants will need to consider how these payment holidays will be treated under the transaction documentation and servicing procedures. In particular, there is a concern that these payment holidays may, pursuant to the transaction documentation or servicing procedures, be required to be treated as "arrears". This is despite the fact that this treatment would seem substantively at odds with mortgage lenders giving payment holidays without having an adverse effect on the borrower's credit rating, which UK lenders have said is their aim[3]. If this is the case, and the payment holidays go on for the full three months, it is relatively common in residential mortgage securitisation documentation that mortgages 90 days or more in "arrears" would be treated as "defaulted". That, in turn, would have attendant consequences on financial triggers – especially in warehouse lending facilities and covered bonds. If use of mortgage holiday schemes becomes widespread, authorities and market participants will need to consider the impact of originators (and especially banks) potentially beginning to struggle to find sufficient eligible collateral.

1 https://www.spglobal.com/ratings/en/research/articles/200313-credit-faq-will-mortgage-payment-suspensions-related-to-covid-19-affect-european-rmbs-11388778

2 https://www.ukfinance.org.uk/press/press-releases/uk-finance-responds-statement-chancellor-regarding-support-mortgage-customers

3 https://www.ukfinance.org.uk/press/press-releases/uk-finance-responds-statement-chancellor-regarding-support-mortgage-customers Where UK Finance says "Firms will make efforts to ensure that forbearance offered under these circumstances will not result in an adverse impact on the customer's credit score."

Beyond temporary financial hardship leading to temporary mortgage payment holidays, COVID-19 may also result in increased rates of actual defaults and arrears, as mortgage borrowers' personal circumstances affect their ability to make scheduled payments, and decreased rates of origination, as the residential property market shrinks due to uncertainty – though it is far too early to say whether this will happen at sufficient scale to have a material impact on residential mortgage securitisation transactions.

Servicing issues

Issues at the servicer level also need to be considered. In connection with financial hardship on borrowers and various schemes for mortgage payment holidays, servicers need to be able to take flexible approaches to their tasks that both protect the interests of the lenders while allowing them to implement schemes. Where the schemes are mandatory (as in Italy and Spain) this will present less of an issue. Where they are non-mandatory (as in the UK), it will still normally be possible for servicers to implement the mortgage payment holiday schemes (e.g. under the customary overriding obligation to act as a "prudent mortgage lender"), but further analysis of the servicer's obligations under the specific servicing agreement will be required.

The other servicing-related issue is, of course, the risk of servicers themselves having difficulty carrying out their roles due to the COVID-19 pandemic – which may increase the risk that servicers (and other counterparties) fail to fulfil their obligations towards issuers (e.g. because they may struggle with a reduced workforce in the office). Depending on the role of a particular counterparty, this could have a wide variety of consequences for securitisation transactions. In the most extreme circumstances (and there is so far no evidence of this happening), failure to perform asset servicing and cash management functions could lead to perfection events, where sales are required to be perfected to sever any ongoing connection with the originator and mortgage borrowers have to be notified. More plausible, however, is the possibility that various counterparties might suffer downgrades as a result of the COVID-19 crisis, resulting in a requirement for the counterparty to replace itself (or post collateral, in the case of a swap counterparty), quite possibly at a point when it is particularly difficult to do so. Even in this scenario, counterparty continuity provisions may also be unexpectedly tested (including back-up servicing arrangements).

Central bank measures

On the other hand, recent announcements relating to central bank funding policies may make securitisation more attractive as a funding mechanism during the COVID-19 crisis.

On 12 March 2020, the European Central Bank announced easing of conditions for its targeted longer-term refinancing operations (TLTROs) and a series of additional longer-term refinancing operations (LTROs) to bridge the gap until the settlement of the next TLTRO in June 2020. The ECB's LTROs are intended to stimulate bank lending by offering long-term funding to banks at attractive rates, collateralised by eligible assets. Eligible assets can include, in broad terms, euro-denominated asset-backed securities, including securities backed by residential mortgages, that meet certain other criteria required including minimum credit quality.

Under the ECB's TLTROs, the amount that banks can borrow is linked to their loans to non-financial corporations and households, with the applied interest rate decreasing as banks lend more. Part of the ECB's announcement was to increase the amount banks are entitled to borrow from 30 per cent. to 50 per cent. of their eligible loans, and the limit on the percentage of eligible loans that may be borrowed in each operation has been removed.

The Bank of England has also announced that its 'Term Funding Scheme with additional incentives for SMEs' (TFSME) will offer four-year funding to banks at a financing cost of around the Bank of England base rate. Again, the amount that banks can borrow will be dependent on their lending profile, with additional funding available to banks that increase lending to SMEs. Similarly to the ECB's TLTROs, asset-backed securities, including RMBS, that meet certain criteria will be eligible collateral.

The TFSME is, of course, in addition to the Bank of England's usual Discount Window Facility through which it already provides liquidity to banks – including through the mobilisation of asset-backed securities as collateral.

These measures are likely to make retained securitisations – where originators securitise assets and retain some or all of the securities issued to be used as eligible collateral, either for ECB LTROs, the Bank of England's TFSME, or other national central bank funding schemes – increasingly popular.

Looking forward

Residential mortgage securitisation is obviously not the only area of the structured debt markets that will be affected by COVID-19. For example, financing of commercial properties will also be affected by the COVID-19 pandemic, especially where cashflows are based on underlying retail businesses. Businesses in the UK and Italy are also benefitting from government assistance in various forms, including payment holidays on loans, temporary stops on tax payments due, grants to certain businesses, and suspension of business rates. As with residential mortgages, it is too early to tell how extensively these will be taken up and whether they will be sufficient to cushion the financial blow dealt by COVID-19.

More broadly, it is still too early to assess or safely predict the impacts of COVID-19 on the securitisation markets, but in the meantime, the features of securitisation that have previously made it an attractive proposition as an alternative source of funding continue to provide compelling reasons for it to continue to do so, particularly during times of increased market instability. The recently announced central bank measures are likely to increase that popularity.

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2003-000288