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COVID-19 AND SECURITISATION: LOCKING DOWN THE LESSONS

In a briefing published in 2020 entitled "FCA Payment Deferrals for Consumers and the Securitisation Market"[1] we concluded that lessons would need to be learned from the first wave of the Covid-19 pandemic in the United Kingdom and that changes would need to be put in place to ensure that financings of consumer assets are robust enough to withstand the prevailing macro-economic headwinds. In this article, we offer a view as to what changes may be needed by drawing on patterns observed in the responses of market participants to the impact of Covid-19 and the measures taken by the UK government and regulators to manage the pandemic on securitisation structures.

This is a reprint of an article originally published on 16 March 2022 as part of our publication "Structured Debt in a New World", accessible here.

Impact of Covid-19 on securitisation

The global spread of Covid-19 has prompted governments and regulators around the world to adopt measures designed to halt or slow the spread of the pandemic. While different sectors of the economy have been affected to varying degrees, a common feature in many industries has been the partial or total interruption of revenue generating activity. A number of measures were taken in order to mitigate the impacts on the UK economy, including national responses at governmental level, monetary responses by the Bank of England and regulatory responses by the Financial Conduct Authority (the "**FCA**").

FCA's general approach

Regulated firms providing regulated credit products in the United Kingdom are subject to a principles-led regime. Those principles inform how firms should treat customers who are in financial difficulty and are set out in the FCA Handbook. Among other things, the Handbook requires firms to pay due regard to the interests of its customers and treat them fairly, a principle which is developed further in the Mortgage Conduct of Business ("**MCOB**") sourcebook in respect of mortgage and home purchase plan products and in the Consumer Credit ("**CONC**") sourcebook in respect of unsecured consumer credit products such as credit cards, consumer loans, high-cost credit and auto-loans. Instead of imposing additional new regulation on firms at a time of national crisis, the FCA's general approach through the pandemic has been to issue guidance setting out its expectations as to how the existing regulatory framework should be applied in light of the fast-changing exigencies of the Covid-19 pandemic, including to consumers facing financial difficulty as a result of it.[2] That guidance included, for a

1 https://www.cliffordchance.com/briefings/2020/09/fca-payment-deferrals-for-consumers-and-the-securitisation-marke.html

2 Note that in limited circumstances, such as some aspects of the persistent debt regime, the FCA has disapplied certain rules inconsistent with its guidance on a temporary basis.

time, the issuing of blanket payment moratoria up to six months in total granted at the request of the debtor, without any assessment being required as to their actual need for forbearance. What is more, such payment moratoria were not permitted to be reported to the customer's credit file.

The FCA's most recent guidance specified that Covid-19 payment deferrals in respect of regulated MCOB and CONC products should end on or before 31 July 2021. Going forward, the FCA once again expects firms to adopt a tailored approach to customers who are experiencing payment difficulties as a result of the impact of Covid-19, including those who continue to experience payment difficulties after having had six months of payment deferrals, within the existing regulatory framework. While payment plans, repossessions and defaults may be considered, such measures must now be tailored and can once again be reported on the customer's credit file. Lenders will therefore also be able to report loans in respect of which forbearance is granted as being in arrears. The FCA maintained this approach even though the UK Government and devolved governments throughout the United Kingdom introduced further measures to limit transmission of Covid-19 in late 2021 following the emergence of the omicron variant.

In addition, during 2021 the new "Breathing Space" regulations (The Debt Respite Scheme (Breathing Space Moratorium and Mental Health Crisis Moratorium) (England and Wales) Regulations 2020) came into force in England and Wales providing access to statutory moratoria for borrowers who have consulted with a debt advisor or are suffering from mental health crisis. For more information see our article entitled "Recent Developments in Consumer Finance: Keeping the engine running" in this collection. A separate regime has applied in Scotland for standard debt issues for a few years.

Commercial property

Separately, tenants of commercial properties were able to access Covid-19 payment deferrals from commercial landlords in respect of rent due, supported by legislative action by the UK Government. The Corporate Insolvency and Governance Act 2020, among other things, introduced a temporary restriction on the use of winding-up petitions until 30 September 2021. While the general restrictions under the Corporate Insolvency and Governance Act 2020 expired on 30 September 2020, more limited restrictions on winding-up petitions presented between 1 October 2021 and 31 March 2022 have been introduced pursuant to the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Amendment of Schedule 10) Regulations 2021 (SI 2021/1029). The Regulations, which entered into force on 29 September 2021, prevent a creditor from presenting a winding-up petition in respect of commercial rent that is unpaid because of a financial effect which results from the Covid-19 pandemic. The UK Government has also temporarily restricted the use of the statutory Commercial Rent Arrears Recovery process by landlords until 25 March 2022. As a result of the Covid-19 payment deferrals granted by commercial landlords, commercial rent arrears in the United Kingdom are estimated to currently stand in excess of £7.5 billion. The UK Government has introduced the Commercial Rent (Coronavirus) Bill to Parliament in order to address the portion of commercial rent arrears accrued as a result of businesses being required to close during the 'protected period' of 21 March 2020 to 18 July 2021. The Bill, if it becomes law (at the time of writing it is awaiting its third reading in the House of Lords), would ringfence commercial rent arrears accrued

during the protected period and introduce a temporary moratorium prohibiting enforcement for non-payment of ringfenced debt until the conclusion of arbitration to resolve the commercial rent dispute or, if no arbitration takes place, six months after the Bill is passed.

Impact of Covid-19 forbearance on securitisations

For securitisation market participants, perhaps the most significant impact of Covid-19 and the forbearance offered to mitigate the impact on debtors has been the temporary reduction in cash flowing through to transaction structures. While the FCA's guidance and other forms of Covid-19 forbearance provided vulnerable debtors with valuable breathing space in the midst of a crisis, increased levels of forbearance create numerous potential issues for securitisation structures which market participants have had to grapple with, most notably:

- practical considerations such as whether structures permit servicers to grant the forbearance envisaged and how to facilitate noteholder meetings during periods when the prevailing public health circumstances make in-person meetings impractical or unwise;
- operational considerations such as how to distinguish between loans in respect of which Covid-19 forbearance was granted on the one hand, and loans which were delinquent or in arrears for reasons unconnected with the impact of Covid-19 on the customer's ability to repay on the other hand;
- economic considerations such as the impact of reduced cashflows on economic covenants (where used), triggers and borrowing base calculations; and
- legal considerations such as the contractual consequences of a payment default should there be insufficient liquidity in the structure to absorb temporary reductions in cash available to the issuer.

Market reactions to mitigate the impact of Covid-19

Common considerations

The impact of Covid-19 forbearance and the resulting potential for temporary liquidity disruptions to be passed on to securitisations prompted two common responses from market participants in the initial stage of the Covid-19 pandemic in the United Kingdom. First, they had to consider *how* Covid-19 forbearance would be granted to debtors whose debt was, at the time, financed by way of a securitisation. Second, investors in securitisations wanted to see different types of delinquency broken out in data sets (as discussed in more detail below under the heading "Data", a practice not common prior to the Covid-19 pandemic) in order to fully assess, among other things, the impact of reduced cash flows from the assets on the issuer's ability to service its debt when considering the existing forms of credit and liquidity support for transactions.

Ability to grant forbearance

The operational question of *how* Covid-19 forbearance would be granted to debtors whose debt was, at the time, financed by way of securitisation required a close reading of the transaction documents. The majority of transaction documents empower servicers to grant forbearance to debtors provided that such forbearance is in accordance with applicable law, the prescribed standard of care and/or the credit and

collections policy of the servicer. Transaction documents prohibited the servicer from granting forbearance to debtors, permitted it subject to creditor consent of some kind, or made it subject to conditions (which usually prevented the servicer from granting forbearance to debtors which had the effect of fundamentally altering the economics of the asset – changing the term of the debt or the principal amount outstanding, for example). The precise analysis, however, was largely dependent upon the nature of the assets being financed.

- In respect of regulated consumer credit, many market participants quickly accepted that servicers had the power to grant Covid-19 payment deferrals pursuant to the FCA's guidance on the basis that servicing agreements generally permit the servicer to act in accordance with applicable law or regulation. Issues were nevertheless observed in certain public deals such as auto-loan receivables securitisations, where the detail of how servicers implemented Covid-19 forbearance had potentially significant documentary consequences. Some public auto deals have historically included the concept of a 'non-permitted variation', in connection with which an extension to the term of a relevant personal contract purchase or hire purchase contract would trigger a buy back obligation on the motor finance company. The 'non-permitted variation' concept was introduced to guard against extension of the term of financed receivables where the financing structure was not designed to absorb extensions, but some motor finance providers found that the buy-back obligation was triggered as a result of servicers granting Covid-19 payment deferrals and extending the term of relevant financed receivables by way of modifying agreements. Other motor finance providers, as a technical Consumer Credit Act matter, characterised Covid-19 forbearance as a unilateral waiver rather than entry into of a modifying agreement. Such Covid-19 forbearance therefore fell outside of the scope of the 'non-permitted variation' regime and the resulting buy-back obligation.
- In respect of non-regulated assets which were not subject to the FCA's guidance, the analysis was more complex. Some transaction documents allowed the servicer to temporarily amend the terms of the underlying loan agreements without the need for investor consent. The 'permitted restructuring' concept was often used by servicers to grant Covid-19 forbearance which changed the economic profile of relevant financed assets, though the extent of the Covid-19 forbearance which could be offered pursuant to such concept depended upon a close reading of the documents to determine precisely what constituted a 'restructuring'.

Data

Prior to the Covid-19 pandemic both private and public securitisations provided data on loan delinquency alongside defaults, but some originators and/or servicers made no distinction between loans which became delinquent due to non-payment (arrears) on the one hand, and loans in respect of which underlying debtors had been granted forbearance under MCOB and CONC on the other. In addition, arrears reporting did not commonly break down the ageing of forbearance. Arrears and forbearance rates may have been sufficiently low that investors did not need to distinguish between types of delinquency in order to fully understand the credit risk position of the portfolio.

In the initial stages of the pandemic in the UK, some investors quickly realised that they wanted to see more data on delinquency type, in order to fully understand the extent

to which they were exposed to assets in respect of which the underlying debtor had been granted forbearance. In order to be able to provide such data, and to comply with the regulatory obligation, where relevant, not to report to the debtor's credit record any Covid-19 forbearance granted pursuant to the FCA guidance, servicers had to consider whether their existing systems and policies and procedures were able to distinguish between: (i) loans which became delinquent due to non-payment on the one hand, and loans in respect of which underlying debtors had been granted forbearance on the other; and (ii) forbearance granted pursuant to MCOB and CONC on the one hand, and forbearance granted pursuant to the FCA's guidance on the other hand. To the extent systems and policies and procedures were unable to do so, servicers had to update them in relatively short order.

Type of securitisation

Private securitisations are typically structured as borrowing base facilities subject to financial covenants which, if breached, lead to structural consequences ranging from early amortisation of the debt and end of the purchase period to triggering an event of default. Alternatively, to the extent the borrowing base is breached as a result of an asset deficiency, there is sometimes an obligation to cure by injecting equity into the structure. Such financial covenants are often drafted by reference to both the portion of the portfolio which is delinquent and the portion of the portfolio which is in default. As a result of the reduction in cash flowing from the assets to the issuer which would follow from an increased number of assets being granted forbearance, market participants were rightly cognisant of the increased risk of financial covenants being breached. Such concerns were particularly felt by non-bank lenders providing regulated credit products because they were expected to follow the FCA's guidance but were unable to access the Bank of England's liquidity schemes. A large number of private securitisations entering into early amortisation or default would have undermined those originators' ability to write new loans at a time when the real economy needed liquidity more than ever.

On the public side, structural features including well-capitalised seller shares, overcollaterisation, liquidity facilities and cash reserves have generally been sufficient to absorb cash flow reductions as a result of Covid-19 forbearance granted in respect of financed assets. Widespread downgrades of rated debt have therefore largely been avoided. Accordingly, market participants can take comfort that public securitisation structures are sufficiently robust to withstand temporary disruptions in cash flow.

This was fortunate because public deals are also cumbersome to amend due to formal noteholder consent regimes requiring in-person meetings. Where amendments to public securitisations were required, participants quickly reassessed the traditional view of a noteholder meeting in light of the evolving public health environment and used existing trustee powers to prescribe additional noteholder meeting regulations. In this regard, we have seen changes to accommodate meetings being held virtually or in a hybrid manner (where some attendees participate in person and some remotely). In addition, market participants have more readily adopted electronic consent provisions in documentation. These provisions permit noteholder resolutions to be passed by noteholders communicating their voting intentions through the clearing systems, without needing to hold a subsequent noteholder meeting. While electronic voting

provisions were crafted some years ago in response to the perceived inefficiencies of traditional noteholder meetings and the accompanying lead-in time for obtaining noteholder consent, virtual and hybrid meetings were specifically driven by public health measures which prevented meetings from taking place in person. Nevertheless, given the additional flexibility that these different options afford to all involved, it is likely that they will continue to be considered for new transactions.

There were also differences in response based on asset class. Notably, the definition of 'delinquency' in credit card, consumer loan and auto-loan securitisations commonly turns on payments being missed *when due*, whereas the definition of 'delinquency' in residential mortgage securitisations normally depends on payment being missed *when originally scheduled*. Covid-19 forbearance generally took the form of a waiver of the debtor's payment obligation or an amendment to the underlying loan agreement to alter the schedule of repayments, though in either case the debtor's payment is no longer due on a date when it was originally expected to be due. As a result, financial covenants in credit card, consumer loan and auto loan securitisations were not as vulnerable to being breached compared to those in residential mortgage securitisations.

Considerations in the short term

Covid-19 forbearance granted to customers of regulated consumer products came to an end on 31 July 2021 and it is unlikely that any Covid-19 forbearance offered by non-regulated firms to customers of unregulated products continued beyond this date either. While it remains to be seen whether large numbers of debtors continue to experience repayment difficulties as a result Covid-19 in the United Kingdom, servicers are now permitted to report missed payments to the debtor's credit file. If this occurs to a significant degree across portfolios then the resulting delinquency spikes once again risk financial covenants being breached, with the undesirable structural consequences described above.

By way of example, although the temporary restriction on the use of the statutory Commercial Rent Arrears Recovery process by landlords is in place until 25 March 2022, it is conceivable that the financial, minimum occupancy, rent yield, LTV and debt service covenants in any CMBS financing such rent receivables may come under stress in the coming months, requiring further waivers to be granted or temporary amendments to such covenants in the short term and/or long-term restructuring.

Considerations for the medium- and long-terms

Going forward, we anticipate that Covid-19 will have a lasting impact on securitisations in three areas:

- **Increased focus on the definitions of "arrears" and "delinquency".** We expect the close reading of these two definitions, which was discussed above, to continue in respect of both existing and new securitisations and in respect of all asset classes. Given that any forbearance, whether granted as a result of special Covid-19 reliefs or for other reasons which cause the debtor to struggle to make a repayment, will mean that a payment is not technically *due*, investors may want to either move towards the position of defining delinquency by reference to a payment missed when *due* rather than a payment missed when *scheduled* in order to avoid being caught

unawares by any future temporary delinquency spike. Alternatively, investors may wish to specify that a subset of forbearance does not count towards the definition of arrears (for example, payment holidays of up to and including three months) but that any forbearance above and beyond this level will count. A more bullish approach would be for investors to adopt the position that all future forbearance will count towards arrears.

- **Continued investor demand for more granular delinquency and default data.** We expect that investors will continue to request, where relevant for a particular transaction, more data on forbearance and with a high level of granularity to enable them to fully appraise the risk position in an economic environment which is strongly influenced by a fast moving and ongoing public health crisis. We expect the type of forbearance (irrespective of whether it is Covid-19 forbearance), the number of defaulted loans, the month-by-month aging of forbearance and the number of loans in respect of which forbearance has ever been granted to be reported for some transactions. Others, where delinquency is perhaps less sensitive or where data is not available, may continue to publish data in the same way as before the Covid-19 pandemic. Closely linked to continued investor demand for more data and on a more granular level, we expect market participants will want to examine their transaction documents to ensure alignment with the servicers' systems. Likewise, there will be interest in ensuring the servicers' credit and collection policies are appropriate to ensure that forbearance is properly tagged and tracked operationally, and that it is reflected legally in the transaction documents, all of which is critical to support the ability to provide the data requested.
- **Support for transactions tapering over time.** While originators who securitise assets for funding purposes and who occupy strong market positions may, in particular, wish to continually maintain credit and liquidity enhancements (notably, the seller share and the level of equity in their structures) so as to be able to absorb a temporary cash flow disruption, we expect some of the new structural features introduced into securitisations over the past year to fall away. In particular, new securitisations are not including specific Covid-19 payment holiday reserves, but transaction parties are closely considering the level of liquidity reserves and, increasingly, incorporating liquidity facilities into the structure which can be drawn to fund a cure of a covenant breach.

In addition, we are expecting that electronic consent provisions are likely to be more regularly referenced. Given that agile working looks set to remain popular and the obvious time and cost savings of a more automated process, it may well be the case that physical meetings become even less common than prior to the pandemic. The long-term utility of virtual or hybrid meetings provisions remains to be assessed against the backdrop of recent experience, however. The trustee's existing power to prescribe further regulations allows a broad scope of flexibility which has been extremely useful during the pandemic but it is a discretionary power and subject to the trustee's usual fiduciary duties owed to noteholders. The challenge of writing these provisions more permanently into deal documentation will be to strike a balance between ensuring the framework is sufficiently detailed on the one hand and accounting for specific challenges and evolving practices on the other. Going forward, however, we expect that issuers will want to include an express power that will enable them to request further regulations, rather than relying solely on trustees' powers to do so of their own

accord. Such entitlement would complement the existing power of the trustee to prescribe further regulations, but would enable additional flexibility insofar as the issuer could formally initiate the process to request virtual or hybrid meeting provisions on the basis that to do so is not materially prejudicial to noteholders.

While the trajectory of current governmental policy in the United Kingdom is pointed firmly in the direction of few, if any, legal restrictions of the type which have been so disruptive to revenue generating activities in certain sectors of the United Kingdom economy, the Covid-19 pandemic is not over and the public health situation has shown itself capable of deteriorating quickly as new variants emerge. Patterns may be observed from the responses of market participants to Covid-19 forbearance in the previous stages of the Covid-19 pandemic in the United Kingdom based on the type of securitisation and the purpose of the securitisation. Such patterns may be used to inform discussions regarding the structural modifications required, if any, to transactions going forward as a result of the continuing impact of Covid-19 and the measures taken to control the pandemic.

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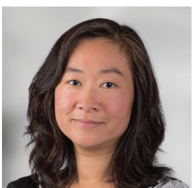

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