ALLEN & OVERY

Covid-19 update

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EBA 22 April 'Statement on additional supervisory measures in the Covid-19 pandemic' – points to note for securitisations

Background

On 22 April 2020, the European Banking Authority (**EBA**) published a "*statement on additional supervisory measures in the Covid-19 pandemic*"[1] (the **Statement**). The Statement clarifies, amongst other things, the application of the EBA's 2 April 2020 "*guidelines on legislative and non-legislative moratoria on loan repayments applied in light of the Covid-19 crisis*"[2] (the Guidelines) to securitisations.

Measures adopted in response to the Covid-19 crisis have included public (legislative) and private (non-legislative) moratoria on payments of credit obligations with the aim of mitigating the short term operational and liquidity challenges faced by borrowers. Moratoria can involve changes to the schedule of payments of assets within their scope, via suspension, postponement or reduction of payments of principal, interest or full instalments, for a specified period of time, with consequent extensions to asset maturity.

The application of moratoria, in a securitisation context, can give rise to a number of potential issues. Key considerations are highlighted in Appendix 1.

1. https://eba.europa.eu/eba-provides-further-guidance-use-flexibility-relation-covid-19-and-calls-heightened-attention-risks
2. https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/Guidelines%20on%20legislative%20and%20non-legislative%20moratoria%20on%20loan%20repayments%20applied%20in%20the%20light%20of%20the%20COVID-19%20crisis/882537/EBA-GL-2020-02%20Guidelines%20on%20payment%20moratoria.pdf

Overview

In overview, the Statement:

Expands on the meaning, in a securitisation context, of the term "*exposures of an institution*". This term is used in the Guidelines to define the scope of general payment moratoria (GPMs, as defined below) that benefit from helpful guidance in relation to the CRR prudential "*default*" definition and forbearance classification. The guidance, in effect, permits exclusion from the benefit of a GPM of assets underlying traditional securitisations that have achieved both accounting de-recognition and significant risk transfer (**SRT**) while allowing assets outside the securitisation to maintain GPM treatment. (For other securitisations, the GPM would need to be extended to the securitised assets in order to maintain the benefit of the GPM for assets outside the securitisation.) In practice, however, we note that the terms of a moratorium may not permit an originator to distinguish between assets based on whether they have been securitised, and that making such distinctions has the potential (in relation to consumer assets, in particular, and depending on the relevant jurisdiction(s)), to conflict with principles of conduct regulation, and/or with the originator's contractual and operational servicing requirements.

Provides guidance in relation to the interaction of GPMs and the implicit support prohibition applicable to SRT securitisations. This guidance (the most notable aspect of the Statement for securitisations) indicates that implementation of a GPM and specified actions of an originator or sponsor in connection with a GPM are not automatically regarded as implicit support, though they must be notified to the competent authority in the usual way under Article 250(3) CRR and the EBA implicit support guidelines. The guidance is striking in light of the concern articulated, in other contexts, by the EBA (and other international regulators) about a perceived tendency of originators, in bad times (including the 2007-8 financial crisis), to support investors for reputational and relationship reasons, and the associated moral hazard. It does not, however, preclude the specified actions completely from constituting implicit support and potentially difficult (subjective) decisions remain. So, for example, there is some room for debate about the point at which action ceases to be "*motivated by compliance with a general payment moratorium*" and becomes "*motivated by reducing the actual or potential losses to investors from the securitised assets*".

Clarifies that it is possible to rely on the Guidelines in calculating certain inputs, used in the formula based approaches to risk weighting securitisation positions (KIRB on the Securitisation Internal Ratings Based Approach (**SEC-IRBA**) and KSA and KA on the Securitisation Standardised Approach (**SEC-SA**)).

Indicates that investors, and originators that have achieved SRT in relation to a securitisation's underlying exposures, do not need to comply with certain regulatory reporting requirements imposed by the Guidelines in relation to their securitisation positions.

The Guidelines

The EBA's 2 April Guidelines relate to the impact of legislative and non-legislative moratoria adopted in response to the Covid-19 crisis under the CRR default definition and forbearance classification. Implementation of a general payment moratorium satisfying specified conditions (a **GPM**) (see Appendix 2 to this briefing summarising the GPM requirements) that is applied to "*all of the exposures of an institution*" within scope of the GPM is stated not to trigger forbearance classification (within Article 47b CRR), or to constitute distressed restructuring (under Article 178(3)(d) CRR). New lending to an obligor subject to a GPM is stated not to trigger forbearance classification, while the counting of "*days past due*" for the purposes of Article 178(1)(b) CRR is stated, for GPMs applied to all of the exposures of the institution within scope, to be based on the revised payment schedule in the GPM.

Falling within the Guidelines' provisions for GPMs could therefore potentially prevent a moratorium from attracting the higher capital requirements associated with defaulted exposures[3] and from contributing to CET1 deductions associated with insufficient coverage for non-performing exposures (**NPEs**)[4]. In a securitisation context, where an exposure's default at the time of selection for inclusion in a securitisation prevents eligibility under the simple transparent and standardised (**STS**) framework[5], and eligibility, for liquidity purposes, as Level 2B high quality liquid assets (**HQLA**), falling within the Guidelines' provisions for GPMs could also prevent exposures from becoming ineligible collateral for future (or replenished) STS securitisations (positions which achieve lower capital requirements than their non-STS equivalents), or HQLA securitisation positions, as a result of a GPM.

The Guidelines indicate, by contrast, that the impact of moratoria not satisfying the GPM conditions, in relation to the default definition and forbearance classification, must be assessed on a case by case basis.

Even in relation to GPMs applied to "*all of the exposures of an institution*", the Guidance indicates that an institution remains required to assess potential unlikeliness to pay, including automatic checks where relevant (typically in relation to retail assets) and manual checks (prioritising manual checks in relation to entities for which the Covid-19 crisis is likely to translate into long term financial difficulties). New lending to obligors subject to a GPM is expected to be undertaken in accordance with an institution's normal credit policies, which would, however, reflect the availability of any public guarantees[6].

The GPM definition includes criteria that may be hard to reconcile with certain relief measures in the market, or the application of which is ambiguous. For example, it excludes: non-legislative moratoria extended by individual banks (requiring co-ordination by a "*material part*" of the banking industry in a jurisdiction); moratoria that apply to new lending (post the date of the moratorium); moratoria whose scope is based on insufficiently "*broad criteria*" or whose application involves assessment of an obligor's creditworthiness; moratoria that permit acceptance after a longstop date envisaged in the Guidelines[7]; and moratoria that change the terms of assets (other than by extending maturity/ providing for catch-up payments to reflect a payment holiday) (see Appendix 2 for details). Diligence is likely to be required in this respect.

The Guidelines impose a reporting obligation on institutions, requiring them to notify their national competent authorities of any non-legislative GPMs applied by them (and impose an obligation on national competent authorities to notify legislative and non-legislative GPMs in their jurisdictions to the EBA).

3. Article 178(1)(b) CRR, Article 178(3)(d) CRR and forbearance classification (via Article 49 of the EBA Guidelines on the application of the definition of default) all feed into the CRR default definition.
4. The forbearance classification also feeds into both the default and the NPE definitions.
5. Article 20(11) STS Regulation.
6. See paragraph 27 of the report accompanying the Guidelines.
7. Currently 30 June 2020, but subject to review by the EBA.

The Statement

Guidance re the meaning of the term "exposures of an institution" in a securitisation context

As indicated in Appendix 1, application of a moratorium can have adverse consequences from the perspective of an originator. The EBA's 22 April Statement clarifies that the reference, in the Guidelines, to the "exposures of an institution" includes, when applied to securitisations, assets in traditional securitisations that remain on the institution's accounting and/or prudential balance sheet, and assets in synthetic securitisations that remain on the originator's accounting balance sheet. Given that synthetic securitisations will generally not achieve accounting de-recognition, this means, in effect, that the assets underlying traditional securitisations that have achieved both accounting de-recognition and prudential de-recognition via SRT may be excluded from the benefit of a GPM without prejudicing reliance on the guidance in relation to the GPM. By contrast, assets in synthetic securitisations, and assets in traditional securitisations that remain on-balance-sheet from an accounting or prudential perspective, must be included in the benefit of a GPM in order to recognise the GPM under the Guidelines.

(The Statement does not address the situation where an originator achieves accounting and prudential de-recognition for securitised assets, but the SSPE issuer is consolidated, or the assets otherwise remain in the prudential consolidation. In the absence of guidance to the contrary, it appears that such assets could be excluded from the benefit of a GPM.)

Although the Statement, in effect, envisages the exclusion from the benefit of a GPM of assets underlying traditional securitisations that have achieved both accounting de-recognition and prudential de-recognition via SRT, we note that, in practice, the terms of a moratorium may not permit an originator applying the moratorium to distinguish between assets based on whether they have been securitised. In the UK, for example, guidance, containing mandatory moratoria, issued by the Financial Conduct Authority in respect of various classes of consumer assets would not permit this. Such a distinction (resulting in different treatment for customers of securitised and un-securitised assets) may, moreover (particularly in relation to consumer assets), conflict with principles of conduct regulation in jurisdictions relevant to the originator such as, in the UK, the requirement to treat customers fairly, and/or with the originator's contractual and operational servicing requirements.

Guidance re implicit support

The Statement includes guidance relating to the interaction of action undertaken in accordance with GPMs and the CRR implicit support regime. Article 250 CRR prohibits originators and sponsors of a securitisation that has achieved SRT (and their affiliates) from, directly or indirectly, "*providing support*" to the securitisation "*beyond* [their] *contractual obligations*" and "*with a view to reducing potential or actual losses to investors*". The regime aims to protect the integrity of the capital relief conferred by SRT: requiring originators and sponsors to treat the securitisation on an arms'-length basis and not re-assume transferred credit risk to protect investors.

The Statement indicates that the suspension, postponement, or reduction of payments under securitised assets, or the granting of new loans, in accordance with a GPM is "*not automatically regarded*" as implicit support, so does not undermine ongoing SRT[8]. This is on the basis that such actions are undertaken in order to comply with the GPM, addressing "*exceptional public health, economic, and market circumstances triggered by Covid-19*" and not aimed at reducing losses to investors. For legislative GPM, actions are, in addition, undertaken in order to comply with law.

8. For example, extending asset maturity in the context of a securitisation where this is a non-permitted variation resulting in a requirement for the originator to repurchase the asset might otherwise be considered implicit support.

The Statement further provides that the following actions of an originator or sponsor are not automatically regarded as implicit support (though they must be notified to the competent authority as for any interaction with an SRT securitisation under Article 250(3) CRR and the EBA implicit support guidelines):

– "*where permitted*" replacing securitised assets within the scope of a GPM with assets of a "*similar risk profile*" that are not subject to the GPM (subject to the securitisation contractual terms governing replacement of assets);

– "*where permitted*" restructuring or amending the contractual documentation as "*appropriate or necessary*" to "*implement or comply with*" the GPM;

– not making claims, during the moratorium period, against the protection provider of a synthetic securitisation in connection with securitised assets subject to a GPM (ie where a credit event has, on its face, been triggered); or

– providing "*upfront liquidity, or other form[s] of financial support*" to a securitisation on a "*temporary basis*" to address a shortfall resulting from a GPM, provided that repayment of the support has the highest seniority in the priority of payments.

The Statement does not indicate that the actions specified above cannot be combined, and, in the absence of such a restriction, it appears possible to combine the specified types of action.
The reference in the first and second bullets to the action being "permitted" is somewhat ambiguous, but is likely to indicate that the Statement does not override the need for contractual rights and/or consent from securitisation contract counterparties in order to undertake the relevant action (rather than requiring an existing contract right[9]). It may be that competent authorities will be open to notification in respect of a general principle of action (ie, we will take approach X to notifying credit events in our synthetic securitisation transactions in light of GPMs Y and Z and applicable accounting and regulatory guidance), rather than requiring notification of each individual instance of action (which could involve large numbers of assets). Banks should confirm the position with their usual supervisory contacts.

The guidance is striking in light of the concern articulated, in other contexts, by the EBA (and other international regulators) about a perceived tendency of originators, in bad times (including the 2007-8 financial crisis), to support investors for reputational and relationship reasons, and the associated moral hazard (see, for example, the EBA's comments re call options in the SRT discussion paper[10]).

As indicated above, the Statement does not preclude the specified actions from constituting implicit support, it merely provides they are not "*automatically regarded as prohibited*".
The Statement confirms that an implicit support notification will still need to be submitted to the institution's competent authority in this respect (under Article 250(3) CRR and the EBA Implicit Support Guidelines). A difficult (and subjective) question in applying the guidance is therefore at what point action ceases to be "*motivated by compliance with a general payment moratorium*" and becomes "*motivated by reducing the actual or potential losses to investors from the securitised assets*". As indicated in Appendix 1, application of a moratorium can have adverse consequences from the perspective of an originator. Action, on arms'-length terms, to avoid consequences that are problematic for the originator may constitute valid grounds for actions of the kind specified in the Statement.
Action motivated by reputational or investor loss-sparing considerations, by contrast, will not. Between these extremes, the Statement could, arguably, be read as permitting action that is neutral from the originator's perspective, ie, as permitting extension, to a transaction and investor, of the treatment that the originator applies to the securitised assets for its own accounting and prudential purposes.

9. Reference to restructuring or amending the contractual documentation to implement or comply with the general payment moratorium to action "where permitted" cannot mean that the contractual documentation already envisages amends to implement or comply with a general payment moratorium.
10. https://eba.europa.eu/sites/default/documents/files/documents/10180/1963391/228098e3-29ba-473f-9e4c-680ce32e1869/Discussion%20Paper%20on%20the%20Significant%20Risk%20Transfer%20in%20Securitisation%20(EBA-DP-2017-03).pdf. See, for example, paragraph 99.

On this reading, if – and for as long as – the originator does not, itself, re-classify the assets or de-recognise them under IFRS 9, or treat the assets as defaulted or non-performing for CRR purposes[11], the Statement might be understood as sanctioning the same analysis by the originator in interpreting/exercising contractual rights against the investor.

Given the serious consequences of implicit support (loss of SRT for the affected transaction, potential issues in obtaining SRT for future transactions under Article 98(3) CRD, public disclosure requirements), however, this would require careful consideration[12], and, ideally, regulatory dialogue. In a deal in which the originator can implement the requirements of a GPM under existing contractual documentation with the investors bearing the risk, this might be the safest course of action.

Guidance re reliance on the Guidelines in calculating KIRB, KSA and KA

The Statement indicates that, where securitised assets include assets within the scope of a GPM, investors and the originator may calculate certain inputs used in risk weighting securitisation positions under the SEC-IRBA and SEC-SA that are based on the capital requirements of the securitised assets had they not been securitised – KIRB on the SEC-IRBA, and KSA and KA on the SEC-SA – in accordance with the Guidelines. This means that KIRB/KSA and KA, and hence the resulting capital requirement of the securitisation position, will potentially be lower due to the deemed absence of default/forbearance. The Statement clarifies that the deemed absence of default/forbearance under the Guidelines is without prejudice to the operation of the securitisation's contractual terms: events of default, acceleration events, credit restructuring events and similar[13].

Guidance re application of the Guidelines' regulatory reporting requirements

The Statement indicates that investors, and originators that have achieved SRT in relation to a securitisation's underlying exposures, do not need to comply with the reporting obligation for institutions imposed by the Guidelines (ie the obligation which requires them to notify their national competent authorities of any non-legislative GPMs applied by them). (The reporting requirement relating to legislative GPMs applies to competent authorities only).

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11. Or classify them as: past due (Art 178(1)(b) CRR), distressed restructuring (Art 178(3)(d) CRR), or forbearance (Art 47b CRR), being sub-definitions within the broader concepts of default and non-performing exposures.
12. It is not wholly clear whether the implicit support guidance above is available only to general payment moratoria that are applied to "*all of the exposures of [the] institution within the scope of the [moratorium]*" (as required in paragraph 11 of the Guidelines and interpreted in accordance with paragraph 32 of the Statement) or whether it also applies to GPMs that are applied to only some of an institution's in-scope exposures within scope, however, the former would be the conservative interpretation (ie that the GPM has to be applied to all in-scope exposures in order to benefit).
13. It is not wholly clear whether this treatment is available only to general payment moratoria that are applied to "*all of the exposures of [the] institution within the scope of the [moratorium]*" (as required in paragraph 11 of the Guidelines and interpreted in accordance with paragraph 32 of the Statement) or whether it also applies to GPMs that are applied to only some of an institution's in-scope exposures within scope, however, the former would be the conservative interpretation (ie that the GPM has to be applied to all in-scope exposures in order to benefit).

Appendix 1

Key potential issues arising from application of general payment moratoria in a securitisation context

Most obviously (though true sale securitisations will typically contain structural mitigants in the form of reserves, liquidity-facilities, over-collateralisation and/or contractual provisions diverting principal receipts to interest cover), cash shortfalls resulting from payment holidays (or restrictions on enforcement in the context of NPEs) can ultimately lead to failure to pay on securitisation notes and third party expenses. This is, principally, an investor/creditor concern rather than an originator concern, other than from a reputational perspective and in respect of retained securitisation positions in securitisations that have achieved SRT.

From the originator's perspective:

– In synthetic securitisations, depending on their detailed drafting (which may mean there is no issue), postponement of payments and maturity extensions associated with moratoria can potentially trigger contractual credit events (such as restructuring[14], or failure to pay[15]) in circumstances in which there is no, or little, loss in practice.

– In both traditional and synthetic securitisations, depending on their detailed drafting (which may mean there is no issue – well-drafted SRT deals, in particular, may include carve-outs to prevent these outcomes), amendments to asset maturity associated with moratoria could constitute non-permitted variations resulting, in traditional securitisations, in a requirement for the originator to re-purchase affected assets or indemnify the securitisation (potentially in volumes that would terminate the transaction), or, in synthetic securitisations, in protection maturity not being extended in line with the extended asset maturity.

– Cash shortfalls and use of reserves may activate triggers relating to reserve and asset replenishment such as cashflow triggers (such as termination of asset replenishment periods, transition from pro rata to sequential amortisation, and/or diversion of income away from (potentially originator-retained) equity positions to senior securitisation positions).

– A stay, or moratorium, on enforcement action may activate contractual delinquency or default definitions for the purpose of on-going reporting and performance, or (in connection with replenishing portfolios) eligibility or triggers[16].

– Servicers in traditional securitisations may be required to notify or seek consent from investors in connection with material servicing changes (particularly in the context of private deals relating to jurisdictions in which legal/regulatory forbearance requirements have not been adopted).

14. Typically only if associated with a credit loss event (ie a debit to P&L).
15. If the definition continues to track the original contractual payment dates and grace periods unaffected by the moratorium.
16. Though payment holidays agreed with the lender generally will not have this effect.

Appendix 2

Summary of General Payment Moratorium Requirements

In order to qualify as a GPM under the Guidelines, a moratorium must comply with the following requirements (in broad terms):

- The moratorium is enshrined in national law (a legislative moratorium), or is a non-legislative payment relief initiative that is "*industry or sector wide*", agreed by "*the banking industry or a material part thereof*" ("*possibly in connection with public authorities*"), and "*open*" (a non-legislative moratorium). (An initiative by a single institution is not regarded as sufficiently broad[17].)
- The moratorium applies to a "*large group of obligors*" defined based on "*broad criteria*" (such as exposure or sub-exposure class, industry sector, product range or geographical location) and its application does not involve assessment of an obligor's creditworthiness. Scope may be limited to obligors that were performing before the Covid-19 outbreak, but not to obligors that were non-performing before the outbreak (where a moratorium applies to exposures that were classified as forborne before application of the moratorium, the existing classification must be maintained[18]).
- The moratorium provides for changes to the schedule of payments only (suspending, postponing, or reducing payment of principal, interest or full instalments) for a specified and "*limited*" period of time. Other terms and conditions, such as the interest rate, must not be changed.
- The same terms apply to all exposures subject to the moratorium (but application of the moratorium need not be compulsory for obligors).
- The moratorium applies to existing lending only, not to new lending after the date of announcement of the moratorium.
- The moratorium was launched in response to the Covid-19 pandemic and is applied before 30 June 2020 (the obligor must have applied and a decision have been made before that date[19]). The EBA, however, reserves the right to extend the deadline[20].

17. See paragraph 19 of the report accompanying the Guidelines.
18. See paragraph 19 of the report accompanying the Guidelines.
19. See paragraph 19 of the report accompanying the Guidelines.
20. See paragraph 22 of the report accompanying the Guidelines.