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12 May 2020

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Structured Finance – Global

# Payment moratoriums disrupt transaction cash flow while helping avoid borrower defaults

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## Summary

Payment moratoriums initiated to help consumers and small businesses weather the coronavirus pandemic will help borrowers with loans in structured finance asset pools avoid default, but will also introduce some risks. Moratoriums, both publicly and privately initiated, will ease payment obligations on obligors across asset classes and geographies. The degree to which delayed payments will affect transaction cash flows depends on the length of the delay and the economic distress, as well as transaction characteristics. However, most transactions have structural features that help mitigate the negative effects of delayed collections.

» **Delayed payments from moratoriums support borrowers but erode transaction cash flows.** Payment moratoriums help limit losses on loans to borrowers who, without the moratoriums, would have otherwise defaulted only as a result of temporary financial hardship beyond the borrowers' control. The delay in payments from borrowers receiving moratoriums, however, increases the risk of interest and principal shortfalls, could lower recoveries on defaulted assets from delays in asset disposition, and heightens maturity risk from lengthened repayment terms.

» **Transaction features help mitigate the negative impacts of cash flow disruptions.** Most structured finance transactions have a range of mechanisms that help soften the negative impact on bond credit quality from the disruption of cash flow from payment moratoriums. These include reserve funds and liquidity facilities, performance-based trigger mechanisms, the availability of principal to meet shortfalls in interest, and servicer advancing requirements.

### Payment moratoriums are available through both private and public channels

Since the onset of the severe economic contraction brought on by social distancing measures intended to combat the spread of the coronavirus, consumer and commercial lenders worldwide have offered payment moratoriums of varying form and scope to provide relief to borrowers facing financial hardship. Government action mandated some moratorium programs, while private lenders developed and initiated others.

Government-mandated payment moratoriums have taken several forms. In the US, the CARES Act requires mortgage servicers to grant forbearance of interest and principal payment for up to 360 days to borrowers with federally backed residential mortgage loans (including those securitized by Fannie Mae or Freddie Mac) if the borrowers ask for it and affirm that they are experiencing a financial hardship during the coronavirus emergency, and includes a 60-day moratorium on foreclosure-related activities on federally backed residential mortgages that began on 18 March. The act also includes up to 90 days of forbearance for borrowers with a federally backed multifamily mortgage loan who have experienced a financial hardship.[1] Italy and Spain, meanwhile, have suspended mortgage payments for homeowners affected by the coronavirus, and the UK has implemented a three-month mortgage holiday.[2]

Lenders are also offering their own private moratorium programs, in some cases in association with other lenders. For example, Canada's six largest banks are offering mortgage payment deferrals of up to six months;[3] the Italian Banking Association announced an agreement for a voluntary 12-month moratorium on principal payments of small- and medium-sized enterprise (SME) loans and leases;[4] and Mexican financial institutions represented by the Mexican Banking Association have agreed to offer borrowers four months' deferral of mortgage principal and interest payments with the option for an additional two months' deferral.[5] Servicers of mortgages in US private-label residential mortgage-backed securities (RMBS) transactions are offering moratoriums similar to those mandated for federally backed loans, and Australian lenders are offering loan payment holidays or deferrals for individuals and small businesses hit by coronavirus disruptions, in many cases of up to six months.[6] Most Chinese auto finance companies have announced financial relief measures to support borrowers amid the coronavirus outbreak, including allowing people to delay loan repayments during grace periods without penalty,[7] and credit card, auto, equipment and small business servicers in the US are increasingly offering extensions or other deferral plans to borrowers affected by the coronavirus.[8]

## Delayed payments from moratoriums support borrowers but erode transaction cash flows

Payment moratoriums reduce transaction cash flow by pushing back scheduled interest and principal payments. However, they help limit losses on loans to borrowers who, without the moratoriums, would have otherwise defaulted only as a result of temporary financial hardship beyond the borrowers' control. The quick recovery of borrowers in the wake of recent natural disasters shows that the offering of temporary relief can be a successful strategy for maintaining loan performance, and borrowers that receive moratoriums during emergencies of limited length are more likely to recover than those that receive them for more personal circumstances.[9]

The circumstances surrounding a moratorium, and how well it addresses the needs of borrowers that are stressed, will help determine its success. Irish RMBS arrears surged out of line with general economic developments, for example, when rumors of debt forgiveness circulated at the end of 2011, suggesting that moral hazard drove borrowers that weren't stressed to fall delinquent.[10] Furthermore, although payment moratoriums generally help borrowers bounce back more quickly than they otherwise would following natural disasters, they could have a different impact in the wake of the pandemic. The coronavirus, severe enough to trigger a material contraction in economic activity across the world economy, is more widespread and will likely affect borrowers for longer than most other disasters.

Payment moratoriums can still negatively affect structured finance transactions, albeit sometimes temporarily or immaterially, even in cases in which they help the borrower avoid defaulting. Delayed payments increase the likelihood of interest and principal shortfalls, for instance, and moratoriums that lengthen timelines to asset disposition can lower recoveries on defaulted loans. Moratoriums that lengthen the terms of loans, meanwhile, heighten the risk that notes are not repaid by their legal maturity dates. Finally, some

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synthetic transactions have an idiosyncratic feature that could lead to transactions classifying delinquencies from forbearance as credit events that lead to asset losses, without exceptions for delinquencies caused by natural disasters.

### Significant payment moratoriums heighten risk of interest or principal shortfalls

Reductions in interest and principal collections for even a handful of payment periods heightens the risk of interest and principal shortfalls on structured finance notes if the proportion of borrowers using moratoriums is high enough. However, the risk is more acute in some asset classes than in others.

Indian ABS, for example, face liquidity risks to note principal and interest payments that are scheduled on a predetermined periodic basis, due to loan collection reductions from a combination of lockdown-related servicing disruptions and a payment moratorium for term loans announced by the Reserve Bank of India in late March. Assuming no collections for our rated Indian ABS, the transactions' cash collateral can cover investor payouts over the next two to three months at the least, but this could be insufficient in the event of prolonged loan collection disruptions.[11]

US auto and equipment asset-backed securities (ABS) transactions with money market notes face risks from insufficient collections early in a transaction's life because they have short terms of up to 13 months. Those short terms leave transactions with little time to recoup missed or late payments. However, because the money market note sizes are small relative to the expected collections during the notes' lives, most of them will be able to withstand large reductions or delays in collections from the underlying pools of assets and still pay off before their legal final maturity dates.[12]

Some US RMBS transactions face the risk of interest shortfalls that they may not be able to recover as a result of weak recoupment mechanisms for missed bond interest payments. Because servicers advance missed interest and principal payments on delinquent and forborne loans that they later recoup with a senior priority on cash collections on all loans, interest shortfalls can occur when servicers recoup advances for large numbers of delinquent borrowers within a few months. In many pre-crisis US subprime and Alt-A RMBS transactions, such interest shortfalls can become permanent because unpaid bond interest is often reimbursed from excess interest collections only after overcollateralization has built to a pre-specified target amount.[13]

In another example, some recent prime jumbo RMBS transactions face risk of interest shortfalls because they have a particular type of stop-advance feature that can lead to a reduction in interest payments to junior bonds. While stop-advance features may lessen potential cash flow disruptions upon advance recoupment and offer greater transparency on actual collections, in these transactions principal collections or liquidation proceeds cannot be used to pay interest on the bonds and there is no alternative source of liquidity to pay interest.[14]

### Long delays in asset disposition risk lower recoveries on defaulted assets

In addition to payment moratoriums, relief measures include temporary reprieves from foreclosure or other asset repossession, notably with regard to vehicles backing defaulted contracts. Such moratoriums heighten the risk of losses in structured finance transactions if they delay the disposition of assets backing defaulted loan contracts.

The UK Financial Conduct Authority, for example, issued guidance to mortgage lenders stating that firms should not commence or continue repossession proceedings against customers irrespective of the stage that the repossession proceedings have reached.[15] The US CARES Act provides for a 60-day moratorium on foreclosure-related activities on federally backed residential mortgages, and many US states have enacted at least some type of restriction on foreclosure-related activities within their jurisdictions. States have also implemented a range of moratoriums related to vehicle repossession.

Foreclosure moratoriums that slow the ultimate liquidation of properties behind defaulted mortgages is typically negative for most types of RMBS because longer timelines generally result in servicers needing to continue covering costs such as taxes, insurance and property maintenance. Servicers can eventually recoup those expenses from transaction cash flow. Likewise, suspensions of auto repossessions that push back their sale in the wholesale used car market could depress eventual liquidation values if the moratoriums result in a glut of vehicles hitting the wholesale auctions at once. The Italian government's measures to contain the spread of the coronavirus, meanwhile, are directly and severely eroding the operability of most of the judicial system, which will delay gross recoveries among non-performing loan securitizations.[16]

### Lengthened repayment terms heighten maturity risk

Forbearance plans that add additional months of principal repayment to the end of loan terms increase the risk that structured finance notes will not be repaid by their legal maturity dates. An increase of forbearance in Federal Family Education Loan Program (FFELP) student loans, for example, would heighten this risk for FFELP ABS. Indeed, we downgraded the ratings on a large number of FFELP ABS notes several years ago after a significant increase in the use of forbearance and deferment in the years following the 2008 financial crisis and later the widespread use of longer-term, income-based repayment programs.

### Forbearance triggers credit events in some synthetic RMBS transactions

Some US credit risk transfer RMBS transactions issued prior to 2015 are at increased risk of losses on loans to obligors receiving forbearance. This is because the transactions are assigned losses with a fixed severity when a loan suffers a “credit event,” a definition that includes a loan becoming 180 days delinquent without any exceptions for loans affected by casualty events such as natural disasters. If servicers act quickly to modify loans during the forbearance period before the loans become 180 days delinquent, however, losses for these transactions will be lower because they would avoid triggering a credit event.[17]

## Transaction features help mitigate the negative impacts of cash flow disruptions

Most structured finance transactions have a range of mechanisms that help soften the impact on bond credit quality from the disruption of cash flow from payment moratoriums. These include reserve funds and liquidity facilities, performance-based trigger mechanisms, the availability of principal to meet shortfalls in interest, and servicer advancing requirements.

### Reserve funds and liquidity facilities help bridge periods of cash flow disruption

Many transactions across asset classes have reserve funds or liquidity facilities that enable transactions to manage timing mismatches between available portfolio collections and payment obligations. The features are usually sized to cover several months worth of payment disruption. Reserve funds or liquidity facilities may only be available to the most senior notes in transactions in which mezzanine and junior tranches are permitted to defer interest; for such deferrable bonds, the unpaid interest portion will either be added to the principal balance or become payable once sufficient funds are available.

Most of the European ABS and RMBS transactions that we rate, for example, have sufficient liquidity to counteract significant cash flow disruptions on senior tranches. Among the consumer (excluding credit cards) and SME ABS and RMBS transactions that we analyzed,[18] most of the senior tranches benefit from liquidity coverage of over 12 months of stressed senior fees and interest on the senior class, even before considering any cash flow from the portfolio. Only 4% of consumer ABS, 14% of SME ABS and 5% of RMBS senior tranches benefit from a reserve fund and/or liquidity facility covering less than three months of payments, considering no pool cash flow.[19]

### Performance-based trigger mechanisms help protect bonds as delinquencies rise

Many transactions have trigger mechanisms that, upon the weakening of delinquency rates, can effect structural changes that help to protect the bonds. Some may alter how principal and interest collections are applied toward principal and interest payments on the bonds; for example, they might protect senior bonds by diverting principal payments toward them that would otherwise have gone toward junior bonds. In another example, revolving transactions can have delinquency-based mechanisms that trigger an early amortization of the bonds.

These mechanisms lose their effectiveness, however, if delayed payments resulting from payment moratoriums are not reported as delinquent. US RMBS transactions generally report borrowers who are receiving temporary relief as delinquent in monthly remittance reports, but European RMBS transactions do not always do so. The European Banking Authority recently published guidance clarifying that payment moratoriums do not trigger classification as forbearance or distressed restructuring if the measures taken are based on the applicable national law or on an industry- or sector-wide private initiative agreed and applied broadly by the relevant credit institutions.[20]

Moratoriums that allow loans that will eventually default to remain delinquent longer can also deprive transactions of excess spread that would have been used to cover losses. In transactions with excess spread release mechanisms based on overcollateralization levels, a delay in the recognition of defaults can keep overcollateralization above target for longer, leading excess spread to leak out of the transaction until the defaults are recognized.

### Servicer advances help bridge payment disruption in US RMBS and CMBS

US RMBS and commercial mortgage-backed securities (CMBS) transactions generally require servicers to advance principal and interest on delinquent loans, a feature that will help transactions maintain cash flow to bondholders in the wake of temporary disruptions from payment moratoriums. Servicers often must make advances up to the point that they deem that further advances would be unrecoverable from proceeds from the liquidation of the property backing the delinquent loan; they can recoup those advances with a senior priority on transaction cash flow when 1) they deem the advance to be nonrecoverable; 2) the borrower returns to current status; 3) the loan is modified; 4) the underlying property is liquidated; or 5) servicing is transferred to another entity. In some RMBS transactions, servicers are required to advance only for a certain period of time such as 120 days, as in Fannie Mae and Freddie Mac RMBS.

Advances help cover for short-term disruptions, but as delinquencies rise, so does the likelihood that the transactions cannot recover interest shortfalls when the servicer eventually recoups its advances, as described above. Large enough amounts of advances also put financial pressure on smaller servicers, particularly in RMBS, that could eventually force them to transfer their duties to another servicer, which heightens the risk of cash flow disruption as the successor servicer takes over. In a scenario in which multiple servicers fail concurrently, servicing transfers will be more difficult to execute, creating additional risk to servicing quality and transaction performance.[21]

Most re-performing loan transactions, meanwhile, do not feature servicer advancing and run the risk of at least temporary interest shortfalls if the percentage of borrowers in forbearance is high. The transaction documents do allow for reimbursement of missed interest payments using excess interest or principal collections or both, but high priority notes must typically be paid off in full before principal collections are redirected to cover missed interest for junior bonds. In addition to the increased risk of interest shortfalls, certain transaction documents require that deferred balances be treated as a realized loss, leading to a write-down of the junior notes.[22]

### Other features also protect against cash flow disruption

Structured finance transactions have other features that mitigate the risks of cash flow disruption from payment moratoriums. For example, European RMBS and CMBS typically provide for the commingling of interest and principal collections such that transactions can use principal collections to cover required note interest payments. Most consumer ABS transactions in the US and Europe also have this feature.

Japanese transactions are typically protected from risks from payment moratoriums through repurchase obligations, under which originators must repurchase modified loans at the price of their outstanding principal and remove them from the securitized portfolios.[23]

Meanwhile, covered bonds benefit from their dual recourse nature in which temporary declines of cash flow into their cover pools will not affect them as long as the covered bond issuer continues to make payments on the bonds.

## Moody's related publications

- Global Macro Outlook 2020-21 (April 2020 Update): Global recession is deepening rapidly as restrictions exact high economic cost, 28 April 2020
- Coronavirus – Global: FAQ on the credit implications of moratoriums on private-sector debt, 22 April 2020
- Structured Finance – Global: Coronavirus economic shock is weakening credit across structured finance, 16 April 2020
- Coronavirus – US: Coronavirus stimulus will lessen economic pain, but credit climate will remain difficult, 10 April 2020
- Coronavirus – Europe: Coronavirus support packages will not fully offset economic disruption, 6 April 2020

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## Endnotes

[1] See Coronavirus – US: Coronavirus stimulus will lessen economic pain, but credit climate will remain difficult, 10 April 2020.

[2] See Coronavirus – Europe: Coronavirus support packages will not fully offset economic disruption, 6 April 2020.

[3] See Structured Finance – Canada: Large banks' six-month mortgage deferrals pose little risk to related securitizations, 2 April 2020 and Credit Card ABS – Canada: Coronavirus-tied job losses, bank consumer relief efforts will erode deal performance, 7 May 2020.

[4] See Structured Finance – Italy: Coronavirus' spread across Italy creates risks for securitisations and covered bonds, 13 March 2020.

[5] See Coronavirus – Latin America: Policy support will mitigate economic damage but will not avert recessions, 7 May 2020.

[6] See Structured Finance – Australia: Loan delinquencies and defaults will increase because of coronavirus disruptions, 31 March 2020.

[7] See Auto ABS – China: Delinquencies will continue to increase on coronavirus fallout after spiking in January, 11 March 2020.

[8] See Auto ABS – US: Surge in loan extensions will slow note payments, signals rising borrower distress, 24 April 2020 and Credit Card ABS – US: Coronavirus fallout will likely erode collateral performance from March levels, 8 May 2020.

[9] See Consumer ABS and RMBS – US: Coronavirus fallout will weaken consumer finances, creating risks for deals, 27 March 2020.

[10] See RMBS: For Russian RMBS, compulsory payment plans for distressed borrowers will reduce excess spread and increase recovery lag, 7 December 2018.

[11] See Structured Finance – India: Coronavirus lockdown will hurt Indian ABS performance, 30 March 2020 and Rating Action: Moody's takes rating action on 13 PTCs issued by Indian ABS transactions, 6 May 2020.

[12] See Auto and Equipment ABS – US: Money market note payoffs will likely withstand coronavirus-tied payment delays, 28 April 2020.

[13] See Rating Action: Moody's places 404 classes of legacy US RMBS on review for downgrade, 15 April 2020.

[14] See Rating Action: Moody's places 18 classes of Prime Jumbo RMBS issued by Sequoia Mortgage Trust on review for downgrade, 27 April 2020.

[15] See Mortgages and coronavirus: our guidance for firms, Financial Conduct Authority, 20 March 2020.

[16] See NPL securitisations – Italy: Coronavirus fallout erodes non-performing loan deal credit quality, 24 April 2020.

[17] See RMBS – US: Coronavirus-tied loan forbearance will spur losses on certain credit risk transfer deals, 14 April 2020.

[18] Our analyzed sample comprises all ABS and RMBS transactions with an investment-grade rating on the senior note, excluding synthetic transactions and credit card ABS.

[19] See Structured Finance – Europe: Structural features within deals help limit coronavirus induced cash flow disruptions, 3 April 2020.

[20] See EBA publishes Guidelines on treatment of public and private moratoriums in light of COVID-19 measures, European Banking Authority, 2 April 2020.

[21] See Non-bank Residential Mortgage Companies and RMBS - US: Tight liquidity drives industry turmoil, 29 April 2020.

[22] See RMBS – US: Coronavirus-tied aid will support mortgage performance, bond effects vary by structure, 11 May 2020.

[23] See Structured Finance – Japan: Coronavirus fallout increases asset risks in consumer deals, 2 April 2020.

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