OUTLOOK
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Structured Finance – Global

H2 2020 Outlook – Underwriting will remain tighter as pandemic's effects continue to weaken collateral performance

Summary

The weak global economy as a result of the spread of coronavirus will lead to tighter-than-expected underwriting in the second half of 2020, and continue to weaken the performance of structured finance transactions around the globe, though in uneven ways across countries. Underwriting has tightened in recent months in many asset classes, and will remain tight for the rest of 2020 relative to our expectations at the beginning of the year. However, consumer and corporate credit quality in general will continue to deteriorate, heightening the risk of performance deterioration among securitizations we rate. The impact of this deterioration will depend on factors including deal structures, the evolution of government actions and payment holidays, and the potential for further outbreaks to harm economic activity.

» **New deal collateral and structures will strengthen in many major asset classes to cope with recessionary performance trends**

» **Collateral performance will remain weak, but negative credit impact of pandemic will be most evident for junior notes**

New deal collateral and structures will strengthen in many major asset classes to cope with recessionary performance trends

Collateral underwriting tightened in H1 2020 in certain consumer asset-backed securities (ABS), residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) markets. And it will remain tighter than before the pandemic for the rest of the year amid recessionary performance trends, supporting asset quality in new transactions.

Collateral standards will remain stronger in many asset classes after tightening in H1

The stronger collateral origination quality will reflect both somewhat raised standards and additional steps to scrutinize borrowers in ways that do not show up in loan data, such as more rigorous employment verification standards. In addition, sponsors in some asset classes will continue excluding or reducing the amount of relatively risky collateral types in deals, including loans subject to payments relief such as forbearance or deferrals, or mortgages on hotel or retail properties. Some sponsors in asset classes such as consumer loan ABS and RMBS will also heighten standards more for specific borrower categories, such as self-employed applicants or consumers with relatively weak credit.

At the same time, in asset classes such as collateralized loan obligations (CLOs), new asset quality has shown better selections. Meanwhile, in asset classes such as US equipment ABS or market segments such as auto ABS from automaker's captive finance units, underwriting has not changed significantly, or collateral pools will include shares of somewhat seasoned loans. In addition, the inclusion of notable shares of loans subject to payment relief in new deal pools will continue to represent a new potential source of risk for some deals in asset classes including US and UK RMBS.

New deals will generally have stronger structures than in early H1

As with collateral, structures of new deals will largely remain stronger than they were in early H1 as investors seek to mitigate or prepare for ongoing credit distress. For instance, in many asset classes, such as CLOs and RMBS, higher subordination levels will often mitigate deterioration in portfolio quality or riskier conditions. CLO reinvestment periods have also generally shortened to three years from five years. In other deals, such as European consumer ABS and RMBS, new transactions will attempt to mitigate risks through more defensive capital structures, higher reserves or other features like repurchase obligations for loans becoming subject to payment holidays.

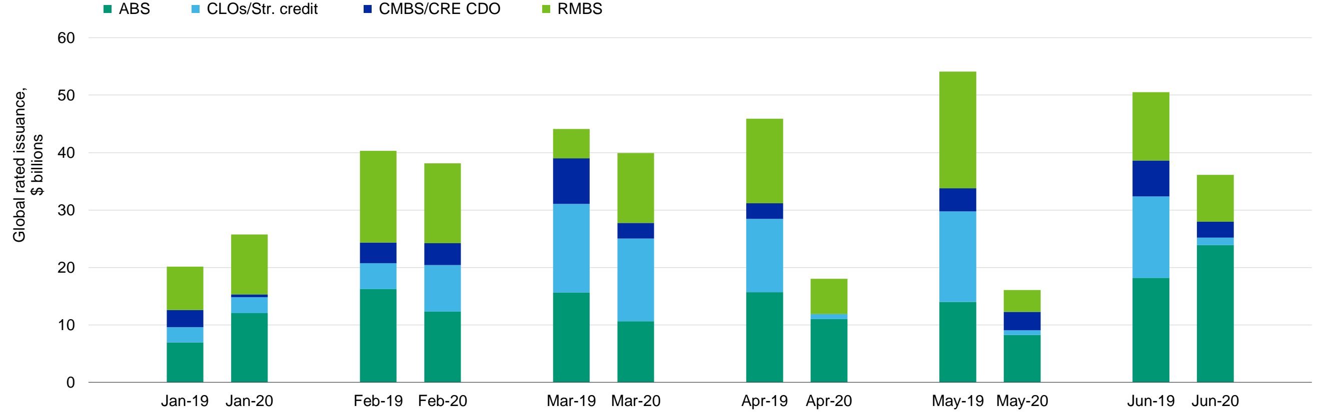
In the meantime, certain asset classes will seek more variety and optionality. For instance, CLOs will allow more management flexibility, and more varieties of CLOs will emerge, such as collateralized bond obligation (CBO)/CLO hybrids designed to access the bond markets, and enhanced CLOs capable of purchasing Caa assets.

Issuance has begun to recover as risk appetites support a wide variety of collateral

Signaling increased risk appetites amid government support for markets and improved economic data, Exhibit 1 shows how securitization issuance has already begun to recover after plunging in April and May. Although fixed-income investors' economic concerns are still suppressing volumes, the collateral of new securitizations in recent months has included material amounts of weaker and more esoteric asset types. In the second half, global securitization collateral will likely continue to include weaker and esoteric asset types unless stalling economic activity significantly heightens investor concerns, as historically low interest rates encourage “reach for yield” behavior.

Exhibit 1

Global securitization issuance has begun to recover after plunging in April and May as a result of the pandemic



Balances of notes that we rated, by definitive rating month
Source: Moody's Investors Service

Securitization of collateral more susceptible to the pandemic's effects, such as speculative-grade corporate debt and commercial property loans, has been especially subdued. But even since the rapid spread of shutdown orders, structured finance issuance has included a wide variety of asset classes. Collateral with weaker credit profiles included non-prime US auto loans, non-conforming Australian loans, and European unsecured consumer loans, as well as some US and EMEA corporate debt and commercial mortgages,

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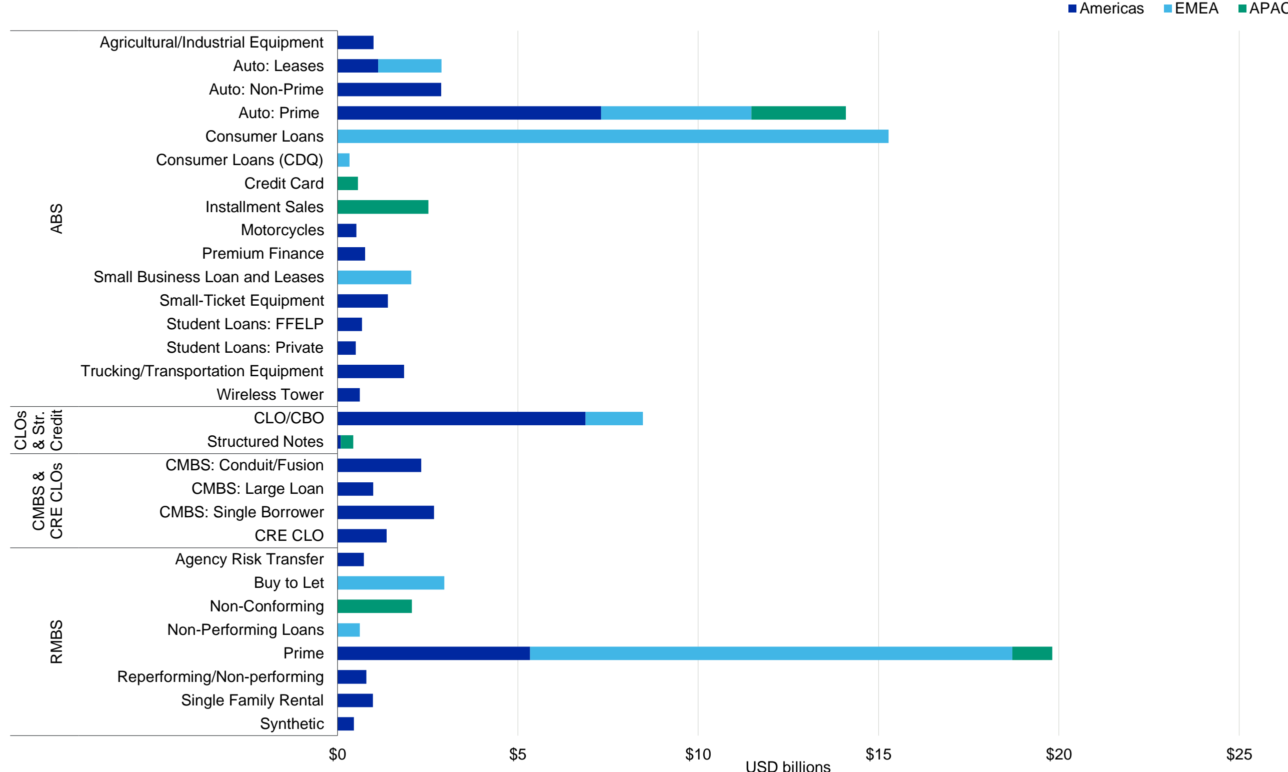
as Exhibit 2 shows. In some cases, the collateral reflected assets on the balance sheets of originators or aggregators before the coronavirus shut markets and new origination volumes plunged among loans such as US online small business loans and US non-prime mortgages. Nevertheless, new origination volumes have begun to restart or recover in many asset classes with higher or more volatile loss profiles, which will support their ongoing presence in securitization markets if conditions remain favorable.

Exhibit 2

Securitization issuance continues to include a wide range of collateral types

Balances of new issuance that we rated between 15 March and 30 June 2020



Based on dates of definitive ratings; certain asset classes not shown or combined.

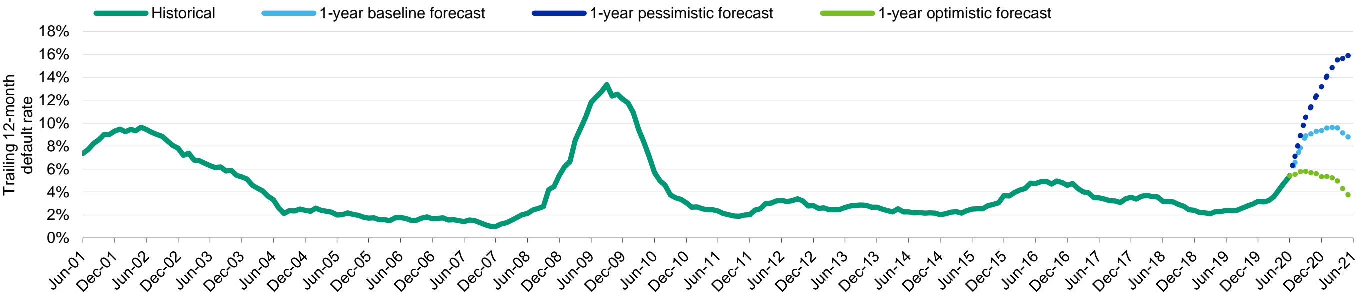
Source: Moody's Investors Service

Collateral performance will remain weak, but negative credit impact of pandemic will be most evident for junior notes

Collateral performance will remain weak, or deteriorate further, across most structured finance sectors for the remainder of 2020 as a result of the COVID-19 pandemic. However, the extent of the deterioration will depend in part on how long the virus persists and how local economies recover. Although uncertainty is higher than usual, our current forecasts reflect our expectations that most economies will resume growth in the second half, but for economic activity to remain significantly lower than last year.

Obligors in certain asset classes, such as US and European CLOs and non-prime/non-conforming consumer-related securitizations, will be more susceptible to deterioration because of their inherently weaker financial strength. As Exhibit 3 shows, we expect the trailing 12-month global corporate speculative-grade default rate reach 9.35% in December, up from 5.4% at the end of June, which was already the highest in a decade.[1] Small business and self-employed borrowers, especially those in industries such as tourism, hospitality and retail, are also particularly exposed to the economic fallout from the coronavirus outbreak, presenting higher risks for securitizations such as SME ABS, equipment ABS tied to small businesses, and certain RMBS and consumer ABS.[2]

Exhibit 3
Global default rate forecast to peak at 9.6% in Q1 2021
12-month trailing global speculative-grade default rate



Source: Moody's Investors Service

Geographies and collateral characteristics will differentiate performance

Major sectors with asset credit quality or collateral performance at risk of deterioration include US CLOs and CMBS, alongside European SME securitizations, Indian ABS, and several RMBS and consumer ABS segments tied to obligors with weaker credit profiles, such as US non-prime auto and unsecured consumer loans.[3]

An asset class's degree of vulnerability will partly reflect the damage done by the pandemic to and subsequent recovery by local economies and industries, including any further rounds of outbreaks. For instance, in India, collateral performance in ABS backed by commercial vehicle and small and medium-sized enterprise loans will continue to deteriorate in the second half as a weaker economy hurts demand for freight transport and weighs on property prices, challenging SMEs.[4] Italian NPL securitizations, along with those from Spain, Portugal, and Ireland, will face pressure from negative investor sentiment and weakening real estate liquidity, exacerbated by a start from a weak position, with no house price inflation in 2019.[5] US private student loan ABS obligors with high incomes such as dentists and nurses have enrolled in payment relief programs at high rates because of disruptions in medical procedures, but will likely mostly resume payments once the pandemic is contained.

Collateral delinquencies and defaults will remain elevated or rise in most structured finance asset classes globally, even as certain metrics improve. For example, the credit quality of CLOs will likely deteriorate over the coming months as asset defaults increase, although credit conditions as reflected in negative rating actions on corporate issuers are stabilizing. The default risk of assets in many CLOs, as measured by weighted average rating factors (WARFs), has already increased, while other performance metrics such as over-collateralization (OC) ratios have deteriorated.

However, exceptions of strengthening performance will also emerge in some asset classes if economic conditions continue to improve, based on experiences to date. For example, asset performance in Chinese securitization transactions backed by consumer debt has rebounded somewhat and will largely stabilize over the next few months unless economic and employment conditions worsen.[6] In addition, asset classes such as wireless tower ABS will remain not significantly effected.

Meanwhile, payment relief will remain prevalent but borrowers in many asset classes will transition out of programs and into delinquencies and defaults, with varying shares recovering to current payment status across different countries, asset classes or servicers. Servicers in some asset classes and regions may more frequently offer moratoriums to nearly any borrower that requests one, regardless of need, while those in others may more often require proof of financial hardship related to the pandemic. In some sectors, government mandates drive high implementation rates and set the terms of the moratoriums.[7]

Within many asset classes, collateral characteristics will differentiate the extent of ongoing performance weakness across deals. For instance, with UK RMBS, borrowers that weathered the 2008 global financial crisis and have since significantly paid down their loans will be in a stronger position than new borrowers, particularly those in the non-conforming sector, supported by significant deleveraging. In Australia, the economic fallout from the coronavirus will pose the biggest risk to collateral performance in ABS and RMBS with large exposures to loans to self-employed or SME borrowers. This includes SME loan ABS, and non-conforming RMBS, which typically include a large share of loans to self-employed borrowers, of 45% on average and as high as 90% in some deals.

Hotel and retail property distress will drive delinquencies in US CMBS loan performance, with some impacts of the coronavirus, such as on office demand, representing longer-term risks.[8] US equipment ABS performance will vary by equipment types, with agricultural and construction ABS bolstered by expanded federal aid and farmers' relatively low dependence on economic conditions. Certain US trucking and transportation ABS deals will have heightened vulnerability.[9] In Japan, credit card purchase receivables by new account holders and cash advance receivables will pose a higher risk than other credit card ABS.[10]

Structural protections will limit tranche impairments

Transaction structural features, such as subordination and mechanisms that direct cash flows to senior notes, will limit impairments of tranches we rate. In some transactions, sponsor actions such as loan repurchases (e.g.,in Japanese RMBS) will also support deals.[11]

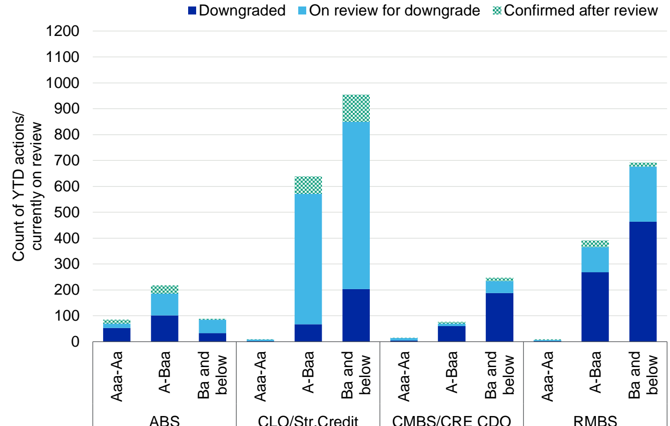
In most asset classes with significant ongoing reductions in cash flows from obligor payment holidays, the declines will present limited risk of missed payments to noteholders because of commingled principal and interest collections, previously sizable excess spread, reserve funds or other protections. For instance, with UK RMBS, most transactions' reserves are currently at target levels that cover around six months of liquidity, on average, which will help pay senior costs and interest on notes amid reduced cash flow from payment holidays and other moratoriums.

However, in asset classes including some US RMBS and student loan ABS sectors, temporary reductions in cash flows from payment relief programs will create greater risks. For example, some post-2010 prime US RMBS deals have stop-advance features that can expose bonds to interest losses from a rise in delinquencies and forbearance. Meanwhile, when servicers recoup their advances with some legacy US RMBS deals upon offering permanent modifications or deferrals to borrowers, transactions could suffer principal write-downs or interest shortfalls depending on the payment waterfall.[12] With US Federal Family Education Loan Program student loan ABS, placing delinquent loans in forbearance results in delayed claim payments on loans that will eventually default, thereby increasing maturity risk for some short-dated bonds.[13] Apart from liquidity risks, for certain securitizations with large exposures to loans in payment holidays, traditional structural protections may be eroded by the loans not being considered delinquent.

Over their lives, many tranches will face heightened risks to their credit quality as a result of the pandemic's ongoing effects on obligors, particularly mezzanine and junior notes, as Exhibit 4 shows. Changes to ratings on low rated (mainly legacy) RMBS led our downgrades, but we also placed many mezzanine and junior CLO tranches on review. At the same time, as Exhibit 5 shows, even among more affected segments, ratings that we downgraded or placed under review represented a minority of notes that we rated. These low shares, despite the sharp downturns in many economies reflected mitigants, to risks for note holders. For example, Southern European RMBS that we rate will largely weather the period of significant distress in the region in part because of the low weighted average loan-to-value ratios of their collateral, increased credit enhancement provided by subordination, and floored reserve funds.[14]

Exhibit 4

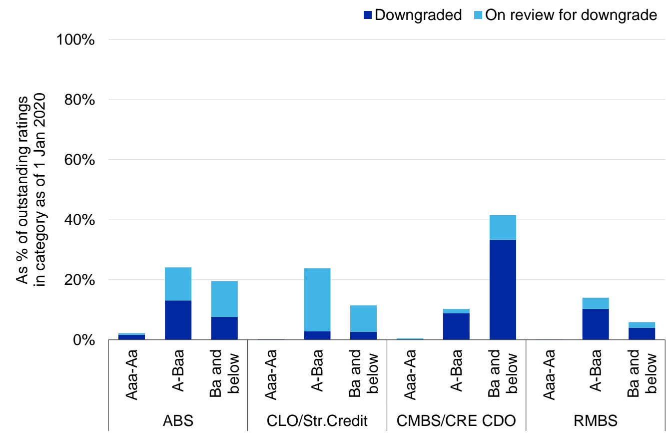
Heightened risk has caused material negative rating actions...



Year-to-date downgrades and confirmations and outstanding reviews as of 17 July 2020
Source: Moody's Investors Service

Exhibit 5

... but only on moderate to small shares of notes we rate



Year-to-date downgrades and outstanding reviews as of 17 July 2020
Source: Moody's Investors Service

Moody's related publications

Selection of key coronavirus-related structured finance research

	High level reports	Differentiating the credit impact	Emerging performance trends
Cross Asset Class	Structured Finance – EMEA: Heat map: SME ABS and NPLs are most vulnerable to coronavirus fallout (20 March 2020)	Structured Finance – Global: Coronavirus economic shock is weakening credit across structured finance (16 April 2020)	Structured Finance – Europe: Widespread but differing payment moratorium programmes will lead to varying default roll rates (15 June 2020)
	Structured Finance – US, Canada & Latin America: Heat map: Bonds most vulnerable to coronavirus are in CLO, CMBS, floorplan ABS and rental car ABS sectors (20 March 2020)	Structured Finance – Global: Coronavirus pandemic will accelerate and reshape credit trends in structured finance (15 July 2020)	CMBS and CLOs – US: Deals with large department store and other retail exposures feel the pain as pandemic continues (15 July 2020)
	Structured Finance – Asia-Pacific: Heat map - Coronavirus fallout vulnerability is high in India, low in Japan, moderate elsewhere (20 March 2020)	Structured Finance – Global: Servicing policy and government mandates drive varying exposure to payment moratoriums (22 July 2020)	Structured Finance – China: Performance is stabilizing after coronavirus-driven deterioration (17 July 2020)
CLO	CLOs – EMEA: Small amount of near-term maturities will soften blow to CLOs from industries most vulnerable to coronavirus fallout (25 March 2020)	CLOs – Global: CLO tranches riskier on coronavirus economic fallout, with rating ramifications (20 April 2020)	CLOs — US: April 2020 Market Pulse: Credit deterioration accelerates due to Coronavirus fallout (19 June 2020)
	CLOs – US: Coronavirus shock will most affect CLOs with weak issuers in vulnerable sectors (31 March 2020)	CLOs – US and EMEA: Shape of downturn, position in capital structure will influence collateral defaults effects on CLO notes (17 April 2020)	CLOs – Global: May 2020 Rating Surveillance Update: Paydowns and refinancing drive deleveraging (23 Jun 2020)
	Middle Market CLOs – US: Credit risk rising from pandemic-related economic shocks, but CLO structures partly mitigate negative effects (1 July 2020)	Structured Finance – US and Europe: CLO credit quality continues to weaken as underlying corporate credit conditions begin to stabilize (11 June 2020)	
RMBS & Consumer ABS	Consumer ABS and RMBS – US: Coronavirus fallout will weaken consumer finances, creating risks for deals (27 March 2020)	RMBS - Australia: Deal features lessen credit-negative effects of coronavirus disruptions (22 June 2020)	Credit Card ABS – Japan: New card holders and cash advances pose heightened risk amid coronavirus fallout (8 June 2020)
	Structured Finance – Japan: Coronavirus fallout increases asset risks in consumer deals (2 April 2020)	Consumer ABS – US: Coronavirus-related borrower relief, credit profiles and deal structures will differentiate tranche risks (7 July 2020)	Credit Card ABS – US: COVID-19 fallout will further weaken yields and payment rates from sharp April erosion (15 June 2020)
	Structured Finance – Europe: Coronavirus shock exposes consumer securitisations to multiple risks (23 April 2020)	RMBS – United Kingdom: Shape of coronavirus related downturn will determine mortgage defaults' effects on securitisation notes (14 July 2020)	RMBS – US: Servicers' inconsistent COVID-19 strategies, reporting dilute performance transparency (20 July 2020)
SME ABS & Corporate ABS	Structured Finance – India: Coronavirus lockdown will hurt Indian ABS performance (30 March 2020)	SME ABS – Europe: Coronavirus induced risks challenge asset quality, but structural features support deals (13 May 2020)	SME ABS – Europe: Coronavirus-related loan guarantee schemes increase SME liquidity, but divergence of terms hampers comparison (23 Jun 2020)
	Rental Car ABS – US: Coronavirus outbreak slashes demand for car rentals and auto sales, hiking deal risks (25 March 2020)	Small Business Loan ABS and Equipment ABS – US: Coronavirus poses record shock to obligors, risk is heightened for unsecured loan ABS (5 May 2020)	
	SME ABS – EMEA: SMEs are highly vulnerable to a coronavirus driven downturn, challenging asset quality (27 April 2020)	Equipment Loan and Lease ABS – US : Coronavirus shock heightens credit risk for transportation, some small ticket ABS (17 June 2020)	
NPL	Non-Performing Loans Europe: Sector update H2 2019: Collections slow with stress expected from coronavirus outbreak (9 April 2020)	NPL securitisations – Italy: Coronavirus fallout erodes non-performing loan deal credit quality (24 April 2020)	
Covered Bonds	Covered Bonds – Canada: Higher asset limit bolsters support as coronavirus spurs delinquencies (6 April 2020)	Covered Bonds Europe: Diverse cover pool seasoning reduces risks from coronavirus-driven house price declines (21 April 2020)	Covered Bonds – Italy: Coronavirus fallout is eroding strong structural protections against payment holiday risks (24 June 2020)
	Covered Bonds Europe: Coronavirus fallout will test covered bond credit quality, but overall strengths will remain (16 April 2020)	Covered Bonds – United Kingdom: Structural features offer limited protection against mortgage payment holiday risks (26 May 2020)	
	Covered Bonds – Asia Pacific: Coronavirus disruptions are negative, but overall credit quality will remain high (19 June 2020)	Banks and Covered Bonds – Finland: Finland's measures support housing market amid coronavirus, but weaken lending standards (2 July 2020)	
ABCP	ABCP – Global: Banks' credit quality will mitigate effects from coronavirus-tied economic drags (9 April 2020)		
CMBS	Office Real Estate – Europe Risks to credit quality are rising as coronavirus effects deepen (19 June 2020)	CMBS Europe: Coronavirus induced pub closures risk covenant breaches for whole business securitisations (27 March 2020)	CMBS – US: Coronavirus impact on hotel and retail driving spike in special-servicing tranStructured Financeers (24 April 2020)
	CMBS – US: Coronavirus fallout further stresses brick and-mortar retail, accelerating fate of poorly positioned properties (21 April 2020)	CMBS – US: Hotel and retail exposures drive increased CMBS risk as coronavirus persists (17 April 2020)	CMBS-US: Moody's DQT - Delinquencies loom as loans impacted by coronavirus progress through late payments (8 June 2020)
	CRE CLOs – US: Structures and portfolio compositions dampen negative effects of COVID-19 (21 May 2020)	CMBS – US: The future of office will be an odyssey not exodus, with uneven credit implications (9 July 2020)	CMBS-US: Moody's DQT - Coronavirus impact leads to largest one month increase in CMBS delinquency history (13 July 2020)

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Endnotes

1 See Default Trends – Global: June 2020 Default Report, 13 July 2020.

2 See Consumer ABS and RMBS – US: Coronavirus fallout will weaken consumer finances, creating risks for deals, 27 March 2020; Structured Finance – Australia: Loan delinquencies and defaults will increase because of coronavirus disruptions, 31 March 2020, SME ABS – EMEA: SMEs are highly vulnerable to a coronavirus driven downturn, challenging asset quality, 27 April 2020.

3 See CMBS – US: Hotel and retail exposures drive increased CMBS risk as coronavirus persists, 17 April 2020; Small Business Loan ABS and Equipment ABS – US: Coronavirus poses record shock to obligors, risk is heightened for unsecured loan ABS, 5 May 2020; Structured Finance – US and Europe: CLO credit quality continues to weaken as underlying corporate credit conditions begin to stabilize, 11 June 2020; and Consumer ABS – US: Coronavirus-related borrower relief, credit profiles and deal structures will differentiate tranche risks, 7 July 2020.

4 See Coronavirus – India: Lockdown compounds economic challenges as credit risks rise in many sectors, 22 May 2020.

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

6 See Structured Finance – China: Performance is stabilizing after coronavirusdriven deterioration, 17 July 2020.

7 See Structured Finance – Global: Servicing policy and government mandates drive varying exposure to payment moratoriums, 22 July 2020.

8 See CMBS – US: The future of office will be an odyssey not exodus, with uneven credit implications, 9 July 2020.

9 See Equipment Loan and Lease ABS – US : Coronavirus shock heightens credit risk for transportation, some small ticket ABS, 17 June 2020.

10 See Credit Card ABS – Japan: New card holders and cash advances pose heightened risk amid coronavirus fallout, 8 June 2020.

11 See RMBS - Japan: Delinquent loan repurchases will moderate defaults amid coronavirus disruptions, 25 May 2020.

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

13 See FFELP ABS – US: COVID-19-tied forbearance delays cash flow, heightens risk for short-dated bonds, 9 June 2020

14 See RMBS – Italy, Portugal and Spain: Structural features and portfolio characteristics will reduce the impact of arrears increase on securitisation notes, 1 June 2020.

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