EUROPEAN STRUCTURED FINANCE 2020 REVIEW AND OUTLOOK: Pandemic and government liquidity measures stymie issuance; collateral relatively unscathed but market awaits true picture of post-COVID economy in 2021.

European structured finance deal flow was significantly impacted by the COVID-19 pandemic – due both to the market disruption it caused, and to the ensuing government liquidity measures that disincentivised many regular issuers from coming to market. There was no sense of panic in the sector, however: after a complete pause in issuance in Q2 and a brief period of spread widening, issuance resumed in May and spreads gradually contracted towards year-end. With a vaccine rollout under way, the market is on a firmer footing going into 2021. But this is not the end of the story: the real test for many deals will come next year when government forbearance and furlough schemes end and the true picture of a post-COVID economy materialises.

According to Sebastien Andre, structured credit portfolio manager at Ostrum Asset Management, the introduction in 2019 of a new European Securitization framework, alongside a high-quality Simple, Transparent and Standardized (STS) ABS label and some extensive due diligence requirements for institutional investors, has led to a securitisation market that is not necessarily more functional but is more orderly, with the emergence of a much more sophisticated and "expert" ABS investor community.

"This has therefore created less panic sales in highly volatile periods," he said. "Along with the unprecedented responses of central banks and governments in 2020 compared with the previous crisis, to both stabilise financial markets and support the real economy, this is ultimately very positive for the credit performance of the asset class and led to a rapid rebound of it. We did not see a massive sell-off but more orderly trading to get liquidity rapidly, and thus better price discovery, when compared with the weak flow and dislocations that persisted for extended periods in 2007/2008."

"We are entering 2021 with a constructive view on European securitised assets on the back of a strong growth rebound expected next year, supported by a widely available vaccine and continued strong support from central banks and national governments," he said. "Although the directionality of spreads has been tighter over the past few months, we think there is still room for an additional spread tightening over a 12-month horizon. Most sectors are still wide of their pre-COVID tights, which could then provide investors with an interesting investment alternative to low-yield corporate credit investments."

The road to recovery is bumpy, however, and from Mr. Andre's point of view, ABS investors should keep a close eye on fundamentals and identify possible pockets of vulnerability in their ABS investments. "While we can take comfort in transaction structures, especially at the upper end of the capital structures (senior and upper mezzanine tranches), certain pockets of collateral remain vulnerable and their potential deterioration could lead to some distortions in affected transactions' cash-flows and ultimately weigh on the performance of most junior tranches."

"The COVID-19 pandemic has also highlighted the need for investors to reconcile financial performance with ESG outcomes," he added. "More and more investors will integrate ESG considerations in their investment decisions, thus paving the way for more sustainable companies and business practices."

2021 issuance forecasts in €60bn-€65bn range

Placed issuance in 2020 was around 30% lower than in 2019 with a total of €75bn, which includes €22.02bn of CLOs. The majority of placed issuance came from UK issuers, while euro-denominated deals dominated retained deal volume. Although primary placement was down, there was a notable rise in secondary market trading volumes. According to Bank of America Securities, €30bn-€40bn of trades was registered within the ABS and RMBS sector.

For the year ahead, bank analysts are forecasting €60bn-€65bn in distributed structured finance issuance, excluding CLOs. Barclays, which expects €65bn in placed issuance, anticipates "significantly lower UK and Dutch prime RMBS compared with historical issuance", after 2020 hit the lowest issuance of the decade (€6bn year to date). Of JPMorgan's €65bn gross distributed supply forecast, the analysts expect STS-compliant issuance to account for €39bn-€42bn. BoA Securities – which expects €64bn in placed supply – expects the majority of issuance to be back-loaded in the year. Deutsche Bank anticipates €90bn in issuance including CLOs, and expects CLOs and auto ABS to dominate, while Morgan Stanley is forecasting c.€60bn of structured finance issuance and highlights that around €8bn in UK non-conforming/buy-to-let transactions will have calls next year.

Chart 1: Placed issuance by asset class 2020

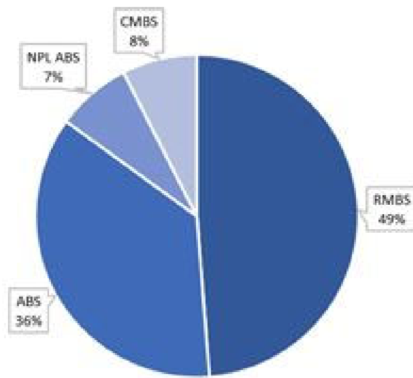


Chart 2: Placed issuance by country 2020

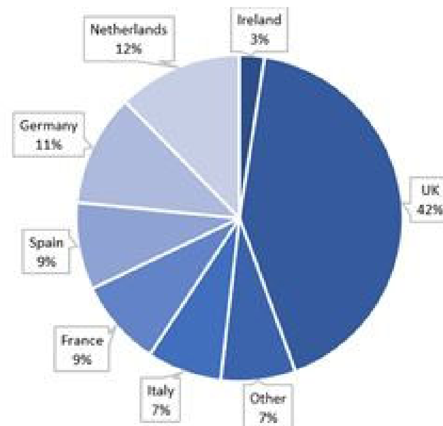
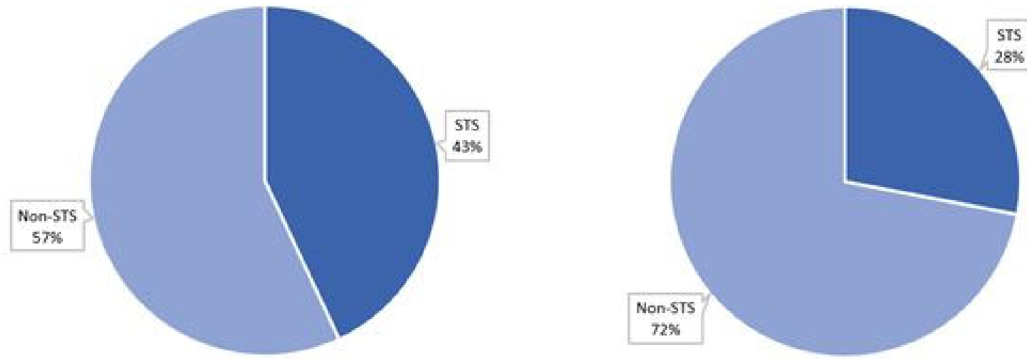


Chart 1: One NPL ABS transaction was a reoffer of a 2019 deal.
Chart 2: 'Other' refers to Finland, Belgium, and Portugal, which issued one deal each; and to a multi-jurisdiction CMBS, Pearl Finance 2020.

Chart 3: STS-compliant and non-STS issuance 2020

Chart 4: UK placed RMBS - STS-compliant vs. non-STS 2020



Deals withstand pressure but 2021 collateral outlook is negative

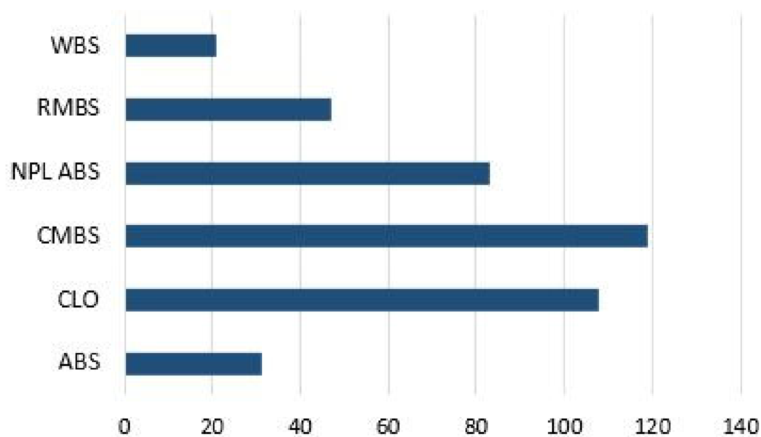
Deal performance was mixed in 2020: COVID-19 induced stresses were most keenly felt in the CMBS and NPL ABS sectors and lower mezz tranches of CLOs, while other asset classes remained relatively unscathed. Next year the picture could be different, however, as rating agencies predict a negative performance outlook for European securitisation collateral.

“While the economic recovery after the pandemic-induced downturn is likely to continue gradually, performance deterioration in securitised collateral has so far been kept in check by government support and payment holidays,” said Christian Aufsatz, head of European structured finance at DBRS Morningstar. “Currently, European headline unemployment numbers continue to understate the true impact of the pandemic on the labour markets as government support in most European countries aims to keep workers in their jobs. Adding net changes in participation rates and average hours worked gives a more accurate picture.”

CapitalStructure's structured finance downgrades tracker identified negative ratings actions taken by DBRS Morningstar, Fitch, KBRA, Moody's, Scope, and S&P on European structured finance transactions following the outbreak of the pandemic in Europe.

CapitalStructure's Structured Finance Downgrade Tracker 1 April to 15 December

Chart 5: Tranche downgrades in the European structured finance sector by asset class, 1 April to 15 December



NB: Certain deals have been downgraded by more than one agency – the tracker counts these downgrades individually, rather than by deal.

Mr. Aufsatz suggests that, going into 2021, economic recovery will support the labour market, but insolvencies and unemployment rates are likely to rise as government assistance is gradually withdrawn, with some sectors being more affected than others. “With the run-off of government support programmes and payment holiday schemes, delinquencies are likely to increase,” he said.

DBRS Morningstar thinks some securitised European portfolios such as NPLs, CMBS, and portfolios with borrowers (SMEs or self-employed) in the most affected sectors will be more strongly impacted by expected performance deterioration than others.

Fitch Ratings, meanwhile, suggests that widespread vaccine availability later in 2021 will alleviate pressures on global structured finance asset performance by reducing the duration of the pandemic and likelihood of lockdown measures, mitigating downside risk in H2 2021. The rating agency says consumer confidence will improve as pandemic-based restrictions ease, but reopening depends on individual willingness to be vaccinated and reducing coronavirus case counts. Unemployment and shutdowns will drag on the economy well into 2021, leading to weakening asset performance in certain structured finance transactions, it adds.

ABS & RMBS: pandemic and government liquidity schemes curtail issuance; Coventry brings new master trust structure

Public securitisation issuance in the ABS and RMBS sectors in 2020 was certainly impacted by the COVID-19 pandemic: the market paused completely in March, with a resumption in issuance kickstarted by German auto ABS **Bavarian Sky 10** in May. Since then, distributed issuance has spanned auto, consumer and RMBS and some CMBS deals, with deal spreads grinding tighter.

Many regular issuers opted to pre-place or retain deals - some deterred by market conditions, others disincentivised by government liquidity schemes. The Bank of England’s England’s Term Funding Scheme with Additional Incentives for SMEs (TFSME), for example, which was launched in March and will run until the end of April 2021, provides between four-year and 10-year funding to eligible institutions. This meant that even though funding costs for prime issuers had come down to viable levels by the end of the year – particularly for senior tranches – little issuance materialised.

Peter Voisey, partner at Dentons, expects prime RMBS issuance to increase in 2021 compared with 2020 levels, with a number of issuers returning to the market, especially into the second quarter and then the second half of the year.

“The Bank of England’s TFSME scheme has provided many banks and building societies, which would normally issue deals, with cheap debt,” Mr. Voisey observed. "While this funding option will remain open and will be used, issuers will nevertheless look to support their existing RMBS programmes and reinvigorate the supply of new paper to their investor base, especially as several existing deals are reaching their call dates.”

Several prime UK RMBS issuers came to market before the COVID-19 crisis hit, including Clydesdale Bank, Nationwide, and Skipton Building Society, but just two in its aftermath: Atom Bank’s Elvet Mortgages and Coventry Building Society’s **Economic Master Issuer 2020-1**.

Economic Master Issuer is the first new UK Master Trust to come to market in over a decade. The timing of its launch in July meant that importance was placed on the deal's COVID-19 risk mitigants. According to Mr. Voisey, who advised Coventry Building Society on programme establishment, these included an exclusion of borrowers with payment holidays in the closing collateral pool and from any revolving sales of further loans into the issuer,

and an obligation for the seller to fund through the seller's note any Class A note share of any principal and interest shortfalls, resulting from a borrower being granted a payment holiday after being sold into the SPV.

According to Mr. Voisey, the deal also included other key distinguishing aspects: “The structure represents an innovative and significant development in the RMBS market by simplifying and enhancing some of the key attributes of the traditional master trusts, which were structured pre-crisis,” he noted.

The first generation of master trusts used three SPVs and a trust, typically established in Jersey, which led to complexity in the documentation and tax analysis, with a knock-on impact on costs and timing of issuances. The new master issuer structure dispenses with the trust and uses only one SPV, which both acquires the loans and issues the notes.

“The programme is extremely versatile as regards funding options,” Mr. Voisey explained. “Notes can be issued as controlled amortisation notes, pass through or bullet maturities. This feature reflects some of the optionality typically seen in covered bond programmes.”

Notes can be issued as STS-eligible series under the EU Securitisation Regulation and, after the transitional Brexit period, the UK STS regime, and can be issued under Regulation S and/or to US institutional investors under Rule 144A; and senior-ranking short-term money market notes can be issued to US money market funds under Rule 2a7 of the US Investment Company Act.

“Unlike the first generation of master trusts, such as the Northern Rock Granite programme, the occurrence of a non-asset trigger (such as a failure to maintain sufficient liquidity in the structure through the seller's note) is curable, so the programme does not need to enter into a permanent amortisation, with a cure meaning revolving sales of loans can be resumed,” said Mr. Voisey. “This is a key enhancement over the earlier models of master trust.”

The seller's note held by Coventry is a very versatile instrument, which serves a number of purposes, including the provision of liquidity and EU and US risk-retention interests in the programme, funding sales of further loans to the SPV, funding further advances and payment holidays, providing principal receipts when needed for senior note redemption, and so on.

“Crucially,” said Mr. Voisey, “the versatility of the structure means Coventry can bring a deal to market in a matter of weeks rather than months, which is beneficial for issuers in rapidly changing market conditions. The loan collateral can be sold into the platform at any time, funded by the seller's note.”

He added that the structure was likely to be of considerable interest to other banks and building societies that have a large origination capacity capable of supporting the platform, and which are keen to build the capability to access the RMBS market with some frequency and with less lead time than is required to bring stand-alone transactions to market.

Non-conforming dominates placed issuance

Issuance in the non-STS RMBS market was fairly buoyant after May, with a spate of publicly issued UK deals launched in a window between June and September. For investors in these deals, a key focus was on payment holiday levels and their potential effects on the transaction. Many issuers of deals during this period carved out loans with payment holidays from portfolios completely, while others put cash into holiday reserve funds to support deals in the short term.

Peak UK payment deferral was high in the non-conforming RMBS sector, with average uptake rates of 20%-30%, according to S&P. In the prime sector the uptake was 15%-20%, and 10%-25% for buy-to-let (BTL) loans.

UK lender Kensington Mortgages issued two deals in the summer: **Finsbury Square 2020-2** and **RMS 32.**

According to Alex Maddox, capital markets and digital director at Kensington Mortgages, portfolio arrears remained fairly stable over the course of 2020, but the main focus for investors was on the number of borrowers

taking payment holidays. “Those levels have dropped to around 2.5% in Kensington’s portfolios,” he said. “In 2021, the focus will be on arrears rather than payment holidays.”

Unsurprisingly, origination levels were much lower than usual between March and September due to the COVID-19 pandemic and warehouse lines relatively empty in September. As a result, Mr. Maddox is expecting a fairly subdued UK RMBS primary market in the first quarter of 2021, even if new-issue spreads have now come down to a level that make sense from an issuer’s point of view - particularly at the top of the capital structure.

Mr. Maddox also notes that origination volumes are beginning to pick up now, but for firms such as Kensington, the main focus in 2021 is likely to be on calls and deal refinancings. Kensington has six deals that are callable in 2021, which if called could be refinanced in two or three new deals.

CMBS: Logistics keep 2020 issuance moving; increased focus on ESG

Almost all corners of the real estate market that underlies European CMBS were hit by the COVID-19 pandemic, curtailing what had looked like a promising year for new issuance and putting existing deals under pressure. However, CMBS 2.0 structures held up relatively well - with some help from the deals’ sponsors - and a CMBS remains a viable funding mechanism for the right collateral going into 2021.

“Banks were unwilling to take on underwriting risk following the pandemic’s outbreak in 2020 due to a lack of clarity over risk and pricing for deals,” said Georghios Anker Parson, partner at Brookland. “This therefore left agency deals backed by COVID-proof assets such as logistics or social housing as the only viable option for the market. As agency deals are not the typical route for sponsors in Europe, issuance was limited primarily to one of the strongest sponsors, Blackstone, which is also the sponsor to have accessed the European CMBS market the most in recent years.”

Three broadly syndicated European CMBS were launched after the start of the pandemic, two of which were backed by logistics assets and one by social housing. Prior to the outbreak, three deals came to market – two with office collateral and one with hotel collateral.

The CMBS market’s focus in 2021 is expected to remain on logistics- or residential-backed deals.

“Office-backed transactions are also a possibility for 2021, particularly with the imminent availability of a COVID-19 vaccine,” said Mr. Anker Parson. “Retail and hospitality-backed deals are unlikely in the short term, however, with the latter being more viable once the threat of renewed lockdowns has gone completely and business and leisure travel levels are back on track.”

With an increasing amount of capital chasing real estate debt – and ESG-accredited debt – deals that comply with ESG investment objectives are expected to play a more significant role in the CMBS market next year. Two deals in 2020 – **River Green Finance 2020** and **SAGE AR Funding No.1** – were front-runners in this regard.

River Green Finance 2020, which priced in January, was Europe’s first Green CMBS. The deal, backed by a single French office asset in Paris, complies with ICMA's Green Bond Principles and joins just one other Green securitisation issuer in Europe – Dutch mortgage lender Obvion. In order to classify River Green Finance as a Green CMBS, the deal's issuer put in place the River Green Finance Green Securitised Bond Framework, which sets out the basis on which the notes are issued in compliance with ICMA Green Bond Principles. Sustainalytics, an independent global provider of ESG and corporate governance research, provided a second-party opinion confirming it as such.

The River Ouest property, referenced in River Green Finance 2020:

Source: River Green Finance 2020 preliminary OC

ESG-conscious investors hoping for more Green opportunities in the CMBS arena may be disappointed – at least in the short term. The European market has a dearth of eligible assets to support significant Green structured finance issuance and, perhaps more importantly, the definitions of Green securitisations and Green assets are not officially determined.

If not Green, then the Social aspect of the ESG spectrum may come into play more readily in 2021. SAGE AR Funding No.1, which priced in October, is backed by social housing properties (affordable rent and social rent). The deal meets the 2020 Social Bond Principles and also achieved a second-party ESG opinion from Sustainalytics.

“CMBS investors, like investors in other asset classes, are keen for ESG exposure and issuers are increasingly looking to find an ESG angle for deals,” said Mr. Anker Parson.

The retail CMBS sector, by contrast, is going through a rough patch, as highlighted by the concentration of downgrades in 2020 in retail-backed transactions. In Italy, one deal, **Emerald Italy 2019**, has seen a loan default and bond shortfalls. Secured on three northern Italian shopping centres, the sponsor, Kildare Partners, did not intervene when the loan defaulted as a result of very low rental collections during the Q2 2020 repayment period. The loan has now been transferred to special servicing.

For other deals that came under pressure due to the pandemic, sponsors generally stepped in. The sponsor of Unite (**USAF II**), for example, a transaction backed by purpose-built student accommodation assets, added 17 extra properties to the securitisation vehicle to negate the impact of a drop in collections brought about by the pandemic. This enhanced the portfolio's market value and projected net operating cash flow by £588.5m and £26.7m, respectively.

NPL ABS: Securitisation exit in focus as European NPL stocks set to rise again

After several years making significant headway with non-performing loan disposals, stocks of bad loans at European banks are once again expected to rise as a result of the COVID-19 pandemic. Government support measures for borrowers across Europe are currently clouding the true picture of expected defaults, but what is

certain is that levels will rise substantially across Europe, with countries with economies reliant on hard-hit sectors such as tourism and hotels likely to suffer more.

Gordon Kerr, head of European structured finance research at DBRS, considers that given the government schemes supporting securitisation, the Italian and Greek NPL securitisation markets will remain the most active, but also expects further transactions from Ireland, Portugal, and Spain.

“Whether there will be securitisations of government-guaranteed loans that were created during the pandemic remains to be seen, but over the longer term, we might see more European securitisations backed by re-performing assets,” he said.

Italy

Italian NPL securitisations gained more attention for the underperformance of deals relative to expectations, rather than deal flow. Nevertheless, four banks completed GACS-compliant deals and recently UniCredit structured Italy’s first GACS-eligible leasing NPL securitisation, **Relais SPV**.

According to Francesco Dissera, managing director at Alantra, the underperformance of NPL securitisations will not necessarily deter investors from the asset class going forward: “The performance of many deals has not been as expected, with the initial business plans perhaps not being prepared as meticulously as they could have been in Italy and certainly not foreseeing the impact of COVID-19, while those of recently structured Greek deals already reflect some COVID stresses,” he said. “I expect that future deals will have more conservative business plans and potential junior note investors will be more rigorous in their investment approach.”

Scope Ratings forecasts that the number of Italian NPL securitisations lagging business plan expectations will increase to 17 from 14 out of the universe of 25 transactions, or 68%, by Q1 2021, with an expected average underperformance of 27% in terms of gross collections versus original business plans.

The stock of Italian NPLs will, meanwhile, rise to €385bn in 2021, with €34bn in new NPL transactions expected to come to market, according to Banca Ifis, which estimates that increased inflows will push bank NPE ratios to 7.3% from 6.2% in 2020, versus an EU maximum target of 5%.

“The government-backed schemes for securitisations in Italy and Greece have proved to be very successful for bringing down banks’ NPL ratios and may incentivise other jurisdictions to roll out similar frameworks,” Mr. Dissera added, “but this could take time to implement.”

Greece

Greece's systemic banks - which prior to 2020 had Europe’s highest levels of NPLs - had been on course to dispose of around €30bn of NPLs in 2020 via large-scale securitisations wrapped by the governmental HAPS guarantee, before COVID-19 put proceedings on hold.

The first round of HAPS guarantees have been drawn down towards **Project Cairo** (Eurobank’s €7.5bn securitisation, invested in by Fortress/doValue), **Project Galaxy** (Alpha Bank’s €10.8bn securitisation with preferred investor Davidson Kempner), and two more projects expected to launch in 2021: Piraeus Bank’s €7bn **Vega** securitisation and National Bank of Greece’s €6bn **Project Frontier**. Projects Galaxy and Cairo included the carve-out of their respective loan servicers, making them particularly attractive to investors seeking to acquire servicing platforms. But according to Tassos Kotzanastassis, managing director, 8G Capital Partners Ltd, future securitisations will not include such platforms and therefore may be more relevant to investors who already own or are affiliated with a servicer on the ground.

“In terms of pricing, the value in Galaxy admittedly lies in the servicing – Cepal will be endowed with €27bn to manage,” he said. “In future projects, pricing will be more a function of the fundamentals: resolution efficiency, timeframes, and of course the value and liquidity of underlying assets. Unforeseen circumstances such as

COVID-19 render contingent pricing and earnout mechanisms all the more important in future securitisations," he said. "As we enter 2021, the pandemic is expected to create up to €10bn of new NPLs, which will be addressed by further securitisations (guaranteed by HAPS II) as well as the AMC (bad bank) proposed by the Bank of Greece, currently under consultation."

Kanav Kalia, director at Oxane Partners, expects Greek deal flow to only pick up by the end of 2021, with a flurry of NPL deals forecast to come into the market during the next two to three years, peaking somewhere around 2022. More broadly, Mr. Kalia thinks the disruption caused by COVID-19 - being of a broader base and impacting industries across the spectrum – means the upcoming NPL pools will have a higher exposure to SMEs assets than in historical portfolios.

"There could also be ample opportunities for chunkier, single-asset deals representing small/mid-sized corporates," he said. "This shift would also mean the investors would look for restructuring these situations rather than pure liquidation of the collateral to target higher returns."

UK

Alongside the continued debate about a European bad bank – or a network of regional bad banks – are discussions about the increased role that securitisation could play in the management of the new wave of NPLs.

In the UK, for example, the government provided billions of pounds in COVID support loans to businesses, via schemes such as the Bounce Back Loan Scheme (BBLS) and the Coronavirus Business Interruption Loans (CBILS). By the end of August, the BBLS had provided £34.2bn in loans to businesses, which, according to the Department for Business, Energy, and Industrial Strategy's annual report, published in September, could incur losses in a range of 35%-60%. For the CBILS, which as of 18 August 2020 had provided £10.5bn of term loans, losses are estimated to be in a range of 10%-25%, as at September 2020.

Nick Colman, managing partner at Alantra, thinks securitisation could theoretically play a vital role in the management of COVID loans such as these in the future. "At present, the UK government guarantee is on the individual loan in a borrower group and the structure for managing this is a short-term fix. Ring-fencing and securitising the loans – and asking the government to support the specific tranches rather than the individual loans – may be a viable solution, with a dedicated servicer assigned to the recovery," he said, adding that with the government as a counterparty, questions still remain as to how to enforce on such loans.

"On past experience, the time taken for portfolios of SME and individual loans to start emerging typically takes T+2 years," Mr. Colman said. "Securitisation could accelerate this process."

Regulatory evolution

Within the past 12 months the regulatory bodies have intensified discussion about NPL securitisations: the European Banking Authority, the Basel Committee, and the European Commission have released opinions, public consultations and proposals for targeted amendments to the regulatory framework for NPL securitisations, with a view to helping the Eurozone economy face the new wave of bad debts. Recently, the European Commission proposed a raft of measures that are currently under debate. These include:

(a) a specific definition of NPE securitisation – i.e. a securitisation backed by a pool of non-performing exposures, the value of which makes up at least 90% of the pool's value at the time of origination;

(b) that risk retention will be based on the 'net value' of the securitised NPEs (i.e. the nominal value net of their non-refundable purchase price discount (NRPPD) agreed at the same time);

(c) that the servicer is entitled to act as risk retainer in case of NPE securitisations. It is also expected that the definition of 'servicer' would be harmonised with that of 'credit servicer' under the Servicers Directive Proposal, once the latter is adopted;

(d) a specific risk weight of NPL securitisations substantially in line with the original proposal of the Basel Committee: i.e. a flat 100% risk weight for senior tranches of heavily discounted securitised NPE portfolios (with NRPPD higher than 50%), a 100% floor to the risk weight applicable to all other tranches on the basis of the existing hierarchy of approaches, and a ban on the use of certain inputs for capital requirements.

On this last point, however, the Basel Committee has more recently revised its position, introducing an exception to the 100% fixed/floor risk weight when a lower risk weight is achieved by applying the external ratings-based approach to non-performing loan securitisation exposures. Committee jurisdictions (including EU) are now expected to implement the change by January 2023.

“We welcome the final position of the Basel Committee, as it takes into consideration concerns raised by many stakeholders”, said Norman Pepe and Fabrizio Occhipinti at Italian Legal Services, a London-based boutique law firm. “The original proposal for a 100% fixed/floor risk weight was likely to have unwanted side effects, disincentivising the creation of higher-quality senior tranche products and pushing the originators of NPE securitisations into a single alternative between relying on sovereign guarantee schemes (such as GACS in Italy or HAPS in Greece) to achieve 0% risk weight, or facing the prospect of 100% risk weight at best.

“This could have led to neglecting the importance of the expertise brought in by external rating agencies in tailoring the calibration of credit risk to the single transaction’s specific features (e.g. taking into account the capital structure, asset quality, credit enhancement, etc.), which would end up resulting in a decreased risk sensitivity within the framework,” they added.

Link to database of publicly placed securitisation deals to 14 December 2020. NB In many cases several tranches were partly or fully pre-placed.