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Drafting issues

Assia Damianova, special counsel at Cadwalader, Wickersham & Taft LLP, considers the potential effect on capital relief trades of the current market volatility arising from Covid-19 restrictions

CRTs typically consist of a credit transfer instrument entered into between the credit institution and an SPV, with notes issued by the SPV to investors, the payments in respect of which are linked to payments on the credit transfer instrument. Most CRTs use a financial guarantee ("FG") as the credit transfer instrument (instead of a CDS that requires daily mark-to-market).

Following the occurrence of a credit event in respect of an asset in the reference portfolio, a cash settlement amount is paid by the SPV to the credit institution under the FG and the principal balance of the notes is written down by a corresponding amount. The notes issued by the SPV may be tranched to suit particular investors' risk appetite.

Credit events
The drafting of the credit events is dictated in part by the requirements of the Capital Requirements Directive in the EU (or other Basel 3 implementing legislation in other jurisdictions). The credit events typically include 'failure to pay', 'bankruptcy' and 'restructuring' in respect of an asset in the reference portfolio. Unlike the standard operation of CDS credit events, under an FG, the credit events will be determined by reference to the servicing principles of the relevant credit institution and will be linked to that credit institution's determination of the likelihood of payment, past due period or, in the case of a restructuring, the time when the profit and loss account of the credit institution has been impaired.

The impact of the current market volatility on the failure to pay or bankruptcy credit events under an FG is likely to be immediate. This is because most CRTs are structured so that a pre-determined assumed loss is paid by the SPV under the FG as soon as the relevant credit event notice is sent, with further payments being made under a true-up mechanism after actual loss is determined - typically after the work-out process of the defaulted asset is complete.

Specific asset class issues
The different asset classes that have been subject to CRTs may present their own challenges during the Covid-19 crisis. For example, the mortgage and other payment holidays that are currently in force in various jurisdictions would not necessarily be anticipated by CRT documentation. Whether a credit event has occurred as a result of non-payment during these payment holidays would depend on the specific drafting in each deal.

Valuations
After a credit event occurs and the assumed loss is paid, the defaulted asset would have to be worked out and the final loss established. Such final loss determination dates now may take longer to occur, given the difficulties with immediate enforcement and/or sale of collateral in the

current market conditions - in particular, some jurisdictions have enacted temporary moratoriums on enforcements against entities such as housing associations and certain business tenants.

This delay in the ability to determine the final loss may result in the application of a fall-back valuation mechanism, although such mechanisms typically involve the use of market bids, which would present its own challenges in the current illiquid markets. In addition, potentially significant interest adjustments may be required in deals that contain make-whole provisions to compensate the investor (where the final loss is smaller than the assumed loss) or the originator credit institution (where the final loss is greater than the assumed loss) for the period between payment of the assumed loss and payment under the true-up mechanism following determination of the final loss.

Finally, regulators have often expressed concerns with CRTs where losses crystallise towards the end of the deal, while the tranches of notes have been amortising on a pro-rata basis resulting in the originating credit institution having a lower level of protection through the FG. Parties that have negotiated specific provisions permitting such pro-rata amortisation (typically based on the credit quality of the reference portfolio) may see renewed regulatory focus on such features.

Recoveries

In determining the final loss, CRTs give credit for recoveries received and applied by the relevant lender in respect of the defaulted asset. Assuming that the Covid-19 crisis results in a slower enforcement process, the treatment of late recoveries may become an issue – again, depending on the terms of the deal documents.

For example, it may be that the originator credit institution is contractually obliged to account for recoveries received even after the final loss for the defaulted asset is determined, and further, it may be that those amounts require verification by a third-party accounting firm by a pre-agreed work-out cut-off date for the relevant deal. In some CRTs, instead of third-party verification, the true-up payment in such circumstances is made on the basis of the actual loss suffered by the originator as recorded or certified by the credit institution.

Replenishments

CRTs involve largely static portfolios with adjustments permitted in limited circumstances, such as in the case of repayments, amendments and/or the refinancing of the underlying assets. The mechanism for replenishments is usually highly negotiated and involves the concept of permitted replacements of like-for like obligations. Depending on the conditions imposed under each deal, during the Covid-19 crisis, replenishments may become more difficult where, for example, internal ratings of the proposed new assets have been reduced and/or some other prescribed procedure for rating confirmation cannot be satisfied. In those cases, the originator credit institution would not be able to take full advantage of its CRT structure.

Early amortisations or termination

There may be some CRTs with early amortisation provisions, such as: deterioration in the credit quality of the underlying exposures to or below a predetermined threshold; losses rising above a predetermined threshold; and/or failure to generate sufficient new underlying exposures that meet the predetermined credit quality. During the Covid-19 crisis, any such triggers will need to be assessed, to determine if any such triggers have been hit.

Generally with CRTs, time calls are used under very limited circumstances and typically cannot be used to provide credit enhancement to investors. In most CRTs, the originator credit institution will only be allowed to terminate the deal for regulatory change events and for clean-up calls.

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