



Finance ADVISORY ■

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Coronavirus and Securitization: Disclosure and Diligence Issues

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In December 2019, a new strain of coronavirus (COVID-19) originated in Wuhan, China, and has spread to infect people throughout the world. As COVID-19 continues to spread, various measures have been taken by governments to reduce the rate of further spread of infection. These measures have adversely affected economies and may lead to a reduction in economic growth or a recession in affected countries. Efforts on a national level in the U.S. to mitigate the economic effects of the response to the coronavirus have included reducing interest rates and the addition of liquidity by the Federal Reserve Bank, and similar actions have been taken by other countries.

In the U.S., the Centers for Disease Control and Prevention (CDC) has declared a pandemic, and on an international level the World Health Organization has declared a pandemic as well. If efforts to treat and contain the coronavirus continue to be ineffectual, the resulting implications for the United States and other countries similarly situated may be severe.

The world of securitization and structured finance encompasses a variety of asset types that have been affected by the outbreak of the coronavirus. Each asset type and transaction presents its own challenges to disclosure and diligence.

Disclosure Issues for Securitization

While there is still considerable uncertainty about the impact of COVID-19, certain basic disclosures should be considered in connection with any securitization.

First, it should be indicated that the coronavirus pandemic has had and will continue to have a macroeconomic impact on the U.S. economy, on other national economies, and on the global economy. In addition to a decline in interest rates, there will likely be an overall decline in economic growth and potentially a future recession. The uncertainty of the depth and reach of the macro effect of the coronavirus is likely to continue to add to market volatility for securitized products, especially by affecting their liquidity and pricing.

Second, the coronavirus may have disproportionate regional effects throughout the U.S., depending on the location of individual community outbreaks, the ability to contain such outbreaks, and the responses taken in each affected area. When crafting disclosure related to the coronavirus, the drafter should be mindful of the appropriateness of a regional focus when states, regions, or localities have been adversely affected. Over time, a more general approach may be taken.

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Third, the collateral for the securitization should be evaluated to determine whether it is more likely to be particularly impacted by the coronavirus. Here are some thoughts for the three major asset classes:

- **RMBS:** Fannie Mae and Freddie Mac have already reminded servicers to consider forbearance as a solution for borrowers affected by the coronavirus. This may be extended to an outright requirement for forbearance, such as was instituted in Italy.
- **CMBS:** Hotel and retail properties may be more directly adversely affected than office buildings, multifamily properties, or other types of commercial real estate assets. Hospitality and, to a lesser extent, retail properties are highly dependent on tourism and the willingness of individuals to frequent stores and restaurants. Tourism is impacted by a myriad of conditions, from local, regional, and global economic health to the stability of the job market, lagging consumer confidence exacerbated by a concern of exposure to the coronavirus, and the existence of travel bans. As a result, hospitality and non-needs-based retail properties may begin to experience sharp declines in attendance and sales. For office properties, while more office workers are being instructed to work from home due to concerns about the spread of the coronavirus, the dislocation of workers will not necessarily impact the borrower's ability to make regular rental payments on its office space. Finally, depending on the particular transaction and the specific collateral concentrations contained within the pool of commercial mortgage loans, individual disclosures in the related offering document may be warranted for assets whose cash flows most directly correlate to property types that are most likely to be directly economically impacted by concerns over and the impact of the coronavirus.
- **ABS:** The concerns for forbearance and foreclosure for RMBS may still exist, especially for consumer assets such as auto loans. Securitizations of these types of assets will also be affected by the overall health of the underlying industry. Certain types of assets, such as small business loans, will be heavily affected by concentration risk in various sectors. Others, such as airlines, may be adversely affected as a whole. It should be noted that the effect of the coronavirus pandemic on certain areas of ABS, such as unsecured consumer loans, is particularly unpredictable.

Fourth, disclosures should note that the coronavirus may affect the transaction parties to the securitization, both their financial health and their ability to service the assets. This disclosure should be informed by any diligence conducted on the transaction parties and any issues that might be uncovered. Servicers of securitized assets may be adversely affected by the capacity and ability of their remote-access systems to accommodate quarantined workers. Trustees, note or certificate administrators, benchmark replacement agents, operating advisors, and other similarly situated parties will also face similar tests of their infrastructure and their ability to perform necessary securitization support functions remotely.

Diligence Issues for Securitizations

Two key diligence questions should be the focus when evaluating the coronavirus pandemic risk to a securitization. The first is asset-specific: is the particular asset type more likely to be adversely affected by issues related to the coronavirus? The second question is whether the ongoing obligations of the transaction parties are likely to be adversely affected in a manner that affects their ability to perform their securitization obligations.

Examples of questions appropriate to ask a sponsor or servicer about the assets may include the following:

- Sponsor: Has your recent ability to originate loans been adversely affected by coronavirus concerns?
- Sponsor: Will the coronavirus pandemic adversely affect the financial condition of your company and/or your ability to honor any repurchase obligations it has in connection with breaches of representations and warranties or document defects?
- Servicer: Will the coronavirus pandemic adversely affect the financial condition of your company or your ability to service the assets of the securitization trust?
- Both: Do you expect to make any accounting or other disclosures or issue any press releases related to the coronavirus and its impact on your business?
- Both: Do you rely on foreign suppliers for any portion of your business operations (including software or the use of offshore call centers)?
- Both: Are your employees able to work from home so that general day-to-day workflow is not compromised?
- Both: Do any of your employees work in environments such as call centers that require close proximity with other employees, which could result in greater risk of the spread of the coronavirus?
- Both: Is the company's technology sufficient to support a large number of people working from home?

In addition, asset-specific questions, particularly in the areas of CMBS and certain types of ABS, might be appropriate for collateral assets whose revenues may be dependent on travel, tourism, in-person shopping, or other situations where people congregate for work or leisure, where the cash flow of the property is dependent on the attendance of crowds, and that may be impacted by quarantines and a general hesitancy of people to travel or congregate, such as:

- Have there been cancellations of conferences or other meetings specifically due to concerns about the coronavirus at any hospitality properties in your portfolio?
- Is the main source of net cash flow and general revenue for a specific collateral asset directly depend on the hospitality and tourism industry? Assuming a continued decline in local, regional, and global tourism and the imposition of further travel bans, how much of a decline in revenue can the property withstand and for how long before the related loan is in danger of payment default?
- Have same-store sales over the comparable period last year demonstrated a decrease in traffic to the property following the coronavirus outbreak?

The foregoing are suggestions offered as some helpful guidance rather than our view on what would be required for each transaction. It cannot be emphasized enough that the effect of the coronavirus pandemic and proposed and actual responses of governments and regulators on all levels seem to be changing daily. Proposals are being made and guidance is being suggested that can have a significant effect on securitizations if enacted or followed. Being informed of recent developments is essential in this area.

Additional Thoughts

For those looking to access the securitization market against the backdrop of the spreading coronavirus pandemic, responsible disclosure and diligence must recognize the risks of the coronavirus, both to the health and welfare of society and to economies throughout the world. As the situation continues to evolve daily and its effects remain far-reaching, the foremost hope is that the health issues can be addressed imminently, offering respite to those stricken and comfort to those living in quarantines. Until the virus begins to significantly retreat and, hopefully, a vaccine is found, it is important that securitizers take into consideration disclosure and diligence concerns.

Alston & Bird has formed a multidisciplinary [task force](#) to advise clients on the business and legal implications of the coronavirus (COVID-19). You can [view all our work](#) on the coronavirus across industries and [subscribe](#) to our future webinars and advisories.

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