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The impact of COVID-19 on securitisations in Asia

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Securitisation is one of the most important debt funding and risk management channels for corporates and financial institutions in Asia. The key feature of asset-backed securitisation ("ABS") bonds is that their interest and principal payments rely on the income received and receipts collected by the underlying assets. Such underlying assets include credit card receivables, auto loan receivables and residential mortgage loans which have been sold by the originators. Hence, it is important that the securitisation capital structure is able to withstand any stress period during the transaction tenor. In particular, the senior notes, i.e. the "AAA" rated tranche, must be able to be fully repaid by the legal final maturity.

The 2008 Global Financial Crisis demonstrated the strength of Asian securitisations. At that time, the Asian securitisation market was relatively new. In order to enhance the credibility of Asian securitisation bonds, many Issuers of Asian ABS bonds had the bonds "wrapped" or guaranteed by AAA-rated monoline insurers. Since the 2008 crisis, many monoline insurers have disappeared or gone insolvent, but the Asian ABS bonds that they have wrapped or guaranteed have remained standing strong and outlived them.[3] Will the 2020 COVID-19 crisis again prove the strength and resilience of Asian ABS bonds?

The World Health Organisation (WHO) declared COVID-19 a pandemic on March 12, 2020. In order to minimise the toll on human health from COVID-19, governments around the world implemented travel bans, quarantine, and mandatory lockdowns. To avoid resulting large-scale defaults and insolvencies, governments also introduced debt forbearance schemes and standstill legislations under which businesses and consumers were allowed payment deferrals.

As the performance of ABS bonds is dependent on cash flows from underlying consumer receivables, such debt forbearance and payment deferrals would inevitably create stress on ABS bonds. In this article, we will examine the impact that COVID-19 and the resultant forbearance measures have on securitisations in Asia.

Legal considerations and developments from COVID-19

Both common and civil law recognise situations where events may arise that were beyond the control of contracting parties at the time of contract. This includes situations which justify forbearance on the performance of contractual obligations.

Article 7.1.7 of the UNIDROIT Principles of International Commercial Contracts (which seeks to harmonise common

and civil contract laws around the world) defines the legal doctrines of force majeure and frustration as follows: "... *if that party proves that the non-performance was due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences*."[4]

We shall briefly examine these concepts below.

Force majeure

In China, the government has issued force majeure certificates to help exempt Chinese exporters from their contractual agreements with overseas buyers.[5]

Force majeure originated as a civil law concept. In common law jurisdictions, force majeure must be expressly provided for in a contract to apply.

Force majeure clauses in contracts generally address circumstances beyond the contracting parties' control, which may render performance under a contract substantially difficult or impossible. Since force majeure clauses are based on contract, their interpretation will depend on the relevant contract.

Frustration

Unlike force majeure, which must generally be spelt out in contracts for it to apply, the legal doctrine of "frustration" applies as a matter of common law. In certain Asian jurisdictions, it may also arise by operation of statute.[6]

Compared with force majeure, frustration is a narrower concept that applies when the actual performance of the contract is radically different from what the parties intended.

The leading example on frustration is the English case of *Krell v Henry*.[7] In that case, the defendant rented the plaintiff's flat solely for the purposes of viewing the coronation of King Edward VII. When King Edward VII cancelled his coronation in 1902, the defendant refused to pay the balance of the agreed rent. The English Court discharged the agreement because the cancellation of the coronation, which was the "foundation" of the contract, "prevented the performance" of the agreement.

The doctrines of force majeure and frustration are not new. These doctrines have historically not posed any major concern to the securitisation industry because of the high thresholds for these doctrines to apply. [8] For example, in *Li Ching Wing v Xuan Yi Xiong*, [9] the Hong Kong Court considered whether the 2003 SARS epidemic was a frustrating event. In that case, a tenant with a two-year lease sought to invoke the doctrine when he was subjected to a 10-day SARS-related isolation order. This argument was rejected by the Court, which decided that a 10-day period was insignificant in view of the two-year duration of the lease. Although SARS could be an unforeseeable event, the Court decided that it did not "significantly change the nature of the outstanding contractual rights or obligations" of the parties in this case.

However, depending on how long the COVID-19 crisis continues to affect businesses around the world, it would be a matter of time before a reasonable Court could decide that this threshold is met.

MAC clauses

Material adverse change ("MAC") or material adverse effect ("MAE") clauses, like force majeure (in common law jurisdictions), requires express contractual terms. Such clauses enable the invoking party to terminate the contract upon the fulfilment of what parties have defined as a change in circumstances. Events constituting MAC are often broadly defined which leave room for differences in interpretation and disputes.

While frustration requires an unforeseen event, force majeure and MAC involve some degree of foreseeability in the sense that they are contractually provided for but are related to risks which are beyond what the company is expected or likely to encounter.

Unlike force majeure and frustration, which require the impossibility or radical change in the nature of performance, MAC merely requires that the risks involved are ones which parties sought to contract out of.

Force majeure and frustration involve external events that affect performance. MAC can be caused by external events but is primarily focused on the internal effects on the party.

While there is a dearth of Asian authorities on MAC, English common law precedents have indicated that the below requirements are necessary to successfully prove a MAC:

- significant change in the company's business performance;
- the duration of the change should not be temporary;[10]
- there should be a disproportionate effect on the specific company (compared to its industry peers);
- the event is not a contemplated or seasonal risk; and
- the change has to be assessed from the standpoint of a reasonable lender.

MAC clauses are commonly found in securitisation contracts, where such clauses are usually focused on the preservation of solvency of the Issuer, Servicer and other credit support providers. The current COVID-19 crisis may potentially give rise to a MAC event, especially if this crisis continues for an extended period of time.

Standstill legislations

As a result of COVID-19, various governments and regulators have encouraged or imposed forbearance on creditors. For example, in China (the largest securitisation market in Asia with approximately US$500bn in outstanding ABS), the China Banking and Insurance Regulatory Commission has asked lenders to allow payment extensions to borrowers. [11] Similarly, in Hong Kong, the Hong Kong Monetary Authority (HKMA) has encouraged Hong Kong banks to take a 'sympathetic stance' when dealing with customers facing financial difficulty.[12]

In other jurisdictions, legislations have been passed to impose mandatory forbearance (or what we call "standstill legislations"). Examples include the UK Coronavirus Act 2020, which among other things, introduced various new laws, including forcing landlords to wait at least three months before initiating eviction proceedings for non-payment of rent for private and social accommodation.[13]

In Asia, Singapore is one of the first to introduce COVID-19 legislation on April 7, 2020, in the form of the COVID-19 Measures (Temporary Measures) Act ("Singapore COVID-19 Act"). The Singapore COVID-19 Act allows for a temporary suspension of obligations to perform "scheduled contracts"[14] and related legal actions. The inability to perform a scheduled contract has to be "materially affected by COVID-19" and the invoking party has to seek relief.[15] The measures apply to the court and domestic arbitral proceedings, but do not affect international arbitration proceedings. Limitation periods for actions are extended for the duration of the prescribed period.[16] Of particular note, the following are prohibited during the prescribed period:

- enforcement of security over movable and immovable property related to business;[17]
- termination of a scheduled contract where the party is unable to pay rent or other moneys;[18]
- call on performance bonds in construction related contracts;[19] and
- payment of liquidated damages in the event of delay or failure in performance of supply contracts.[20]

Unlike a MAC clause, these temporary measures are the creation of statute. They are suspensory in nature, suspending the right of a party over the prescribed period unlike a MAC clause.

The Singapore COVID-19 Act does not expressly suspend the operation of the MAC clause during the prescribed period when contractual obligations are suspended. Therefore, one could argue that the passing of the Singapore COVID-19 Act


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in itself could trigger a MAC clause. However, if this question was determined by the Singapore Courts, we believe that the Singapore Courts are unlikely to go against the spirit of the Singapore COVID-19 Act. In any event, after the prescribed period, parties can still rely on MAC clauses.

Standstill legislations and the suspension of payment obligations have an adverse impact on the cash flows that support ABS bond payments. If this suspension continues over an extended period of time, it is likely to trigger early amortisation and even default of ABS bonds.

Court closures

In some of the most advanced economies in Asia, Courts have also been closed for months. For example, the Hong Kong Courts were closed from January 24, 2020 till May 4, 2020 due to COVID-19.[21] Although Hong Kong did not pass legislation for mandatory forbearance, the extended Court closure effectively gave an extended forbearance to debtors. Lenders and creditors (and Servicers, in the case of ABS transactions) were unable to take prompt enforcement actions to deal with delinquencies, defaults and insolvencies. This would in turn add stress to the collection of cash necessary to pay ABS bonds.

Impact on securitisations

Hedging contracts

ABS almost always involves the use of derivatives to hedge the risks of transaction mismatch (in particular for currency and interest rates) between the assets' cash flows and the bond payment obligations. The market-standard ISDA Master Agreement is widely used to document such derivative contracts.

It is worth noting that force majeure is explicitly listed as a termination event under the 2002 ISDA Master Agreement[22] (although the 1992 ISDA Master Agreement did not contain any reference to force majeure). Where the ABS is rated, it is critical to the ratings of the bonds that any hedging contract(s) supporting the bond payments must remain effective and in place, and could not be terminated for the duration of the securitisation.

COVID-19 could trigger force majeure termination event under the 2002 ISDA Master Agreement.

The ISDA Master Agreement is, by default, governed by English law. However, there is no general applicable definition of "force majeure" under English law. Whether or not a force majeure event has occurred would need to be analysed on its individual facts on a case-by-case basis. The 2002 ISDA Master Agreement also does not provide an explicit definition for force majeure, but describes the event as one where: "*... it becomes impossible or impracticable ... to perform, receive or comply (or it would be impossible or impracticable ... to perform, receive or comply if such payment, delivery or compliance were required on that day), so long as the force majeure or act of state is beyond the control of such ... such party ... and such ... party ... could not, after using all reasonable efforts (which will not require such party ... to incur a loss, other than immaterial, incidental expenses), overcome such prevention, impossibility or impracticability.*"[23]

It is worth noting that if a "force majeure or act of state" has occurred, the affected party must demonstrate that it has used all reasonable efforts to overcome the effect of that event in order for the force majeure termination event to be triggered under the 2002 ISDA Master Agreement.

The occurrence of a force majeure event under the 2002 ISDA Master Agreement automatically triggers an "8 Local Business Days" Waiting Period (starting from the date on which the force majeure event occurs), and no Failure to Pay or Deliver Event of Default[24] would apply with respect to any related payment or delivery failure during that Waiting Period while the force majeure event is continuing.[25] Under section 6(b)(iv)(2) of the 2002 ISDA Master Agreement, if the force majeure event continues after the Waiting Period has expired, all Affected Transactions may be terminated by either party.

If COVID-19 or any of its resultant events gives rise to a force majeure event and termination of any hedging contract that is critical to support the payment of ABS bonds, then this is likely to result in a catastrophic failure and ratings downgrade of the ABS bonds.

Operational challenges

The role of each service provider (such as the Servicer, Trustee, Paying Agents) is essential to any ABS. The Servicer (which is usually the Originator) performs collection services, collecting the assets' cash flows from the underlying obligors. The Trustee and Paying Agents ensure that the cash is then distributed to the ABS bondholders in accordance with the priority of payments (or "waterfalls") set out in the securitisation documents. The Paying Agents rely on the functioning of central clearing systems like Euroclear, Clearstream, DTC, CMU, etc, to ensure ABS bonds interest and principal are paid on time.

Servicers may face some operational challenges in the current pandemic. Key personnel may struggle to get access to premises or payment platforms in order to perform their functions properly.

Debt forbearance or suspension may give rise to more serious disruptions. Servicers may face difficulties in collecting the cash from underlying assets that is required to service the ABS bond payments. This is particularly so where the underlying assets used as ABS bond collateral are mortgage loans, consumer loans, equipment leases, trade receivables, etc. that enjoy an enforcement "standstill" due to COVID-19 related temporary measures.

If COVID-19 restrictions hinder the Servicer's ability to make collections, this may trigger servicer defaults and termination of the Servicer under the securitisation documents. Obviously, if the servicer termination event is clearly not due to Servicer performance issues, the Trustee may decide not to replace the Servicer (unless required by the specified threshold of ABS bondholders to do so).

Rating impact

Rating agencies rate ABS bonds on the basis of the likelihood of timely and full payments on such ABS bonds. Fitch has noted that "*widespread use of coronavirus-related loan forbearance measures will affect structured finance transactions in ways that go beyond the initial risk of liquidity strain*".[26]

The COVID-19 situation has resulted in a deterioration of cash flows. Cash flow disruptions could breach debt service coverage ratios and other performance covenants. This may trigger early amortisation triggers, cause events of default, and force a wind-down of existing ABS portfolios. This would effectively end the Originator's ability to fund new business. To avoid this, some securitisation originators may decide to repurchase loans – but it has been noted that "only a limited number of securitisation sponsors have so far said they would repurchase loans on payment holidays".[27]

Payment suspensions may also result in "mis-functioning swaps", which could lead to additional loss to the ABS issuers and adversely affect the ABS bonds.[27] Events of default may also trigger swap breakages and terminate hedging contracts that are essential to support the ABS bond payments.

There are of course, credit enhancement and liquidity features in many rated ABS transactions. However, depending on the duration and potential escalation of the COVID-19 situation, such credit enhancement and liquidity features may not be able to support the transaction indefinitely.

An extended COVID-19 situation may also result in rating downgrades of account banks and hedging banks, whose ratings are essential for the ABS bond ratings, and whose downgrades could result in ratings downgrade of ABS bonds as well.

Case study: China securitisations

Although there is some short-term pain, we believe that the Asian securitisation market (especially Mainland China, which is currently the largest securitisation market in Asia by volume) would actually benefit from the COVID-19 crisis in the longer term.

Prior to this crisis, China's economy (which has been consistently rising at one of the fastest rate in the world in the last 40 years) has never been tested by a real crisis in modern times. In the 1997 Asian Financial Crisis, China was relatively insulated due to its strict currency exchange controls. In the 2003 SARS, the epidemic was relatively localised and short-lived. But the current COVID-19 pandemic will be the first real test in China's economy since

China's opening up in 1978. The performance precedents set during COVID-19 of the various securitisation asset classes in China would help rating agencies and investors formulate more accurate assessment models on China's asset securitisation performance during a time of great stress, and this would in turn enhance confidence and the future growth of China's securitisation industry post-COVID.

China's securitisation performance in 1H 2020 due to COVID-19

Fitch Ratings reported on February 3, 2020 that its ratings on China's consumer ABS were insulated from the immediate impact of the COVID-19 outbreak through structural mechanisms embedded in those transactions, including but not limited to sequential turbo repayment structures and fast credit enhancement build-up.[29] On February 17, 2020, Fitch reported that COVID-19 outbreak would adversely affect employment rates and disposable income, which would weaken borrowers' serviceability and increase pressure on China's auto loan ABS performance.[30]

On April 30, 2020, Fitch reported that China had passed its peak operational disruptions and auto loan ABS transactions had not experienced any liquidity shock.[31] On May 13, 2020, Fitch revised the asset performance for China auto ABS and residential mortgage backed securitisations ("RMBS") to negative, but maintained stable rating outlook for other Fitch-rated outstanding transactions.[32] On June 2, 2020, Fitch reported a sharp decline in early delinquency rates for Chinese auto loan ABS transactions.[33]

Moody's reported on February 5, 2020 that the economic disruption caused by COVID-19 would hurt Chinese securitisation by pushing up delinquency rates, cutting interest earnings and slowing principal repayments from the underlying assets.[34] On April 7, 2020, Moody's reported that COVID-19 disruptions took a toll on Chinese auto ABS.[35] On April 29, 2020, Moody's reported that early stage delinquency rates in Chinese auto loan ABS declined in March 2020 after increasing significantly in January and February 2020.[36] On May 21, 2020, Moody's reported that COVID-19 would pose risks for asset performance in China's unsecured consumer loan and credit card ABS.[37]

COVID-19 impact on different securitisation asset classes in China

Our observations of the above asset performance in China's securitisaton market are that COVID-19 tended to impact various asset class performances differently. The ability of the borrowers to pay was adversely affected mainly by the borrowers' lower employment and disposable income, and also partly by payment disruptions caused by the lockdown measures imposed by the government. However, the willingness of the borrowers to pay during this stress period is more obvious in residential mortgage-backed securitisations ("RMBS"), compared to other ABS asset classes like credit cards and auto loans.

In ABS credit analysis, default rates, payment rates and yields are the main drivers for the capital structures. Default rate as one of the inputs in determining the ABS capital structure can be defined by using different delinquency buckets, based on the portfolio delinquency roll rates of different originators. During the COVID-19 crisis, it is obvious that this factor gets impacted more severely than the other factors. Hence, in rating future ABS including the surveillance of the currently outstanding ABS, credit rating agencies need to re-visit their base case default rate assumptions and decide if this is able to cover COVID-19 delinquency rate spikes, which is now expected to be recurring in the future.

In RMBS credit analysis, default probability and market value declines are the main drivers for the capital structures. This asset class' performance in 2020 to date has not deteriorated, as the residential mortgage loan borrowers are still willing to pay and residential property prices have remained stable. However, should there be a default of the underlying residential mortgage loans, credit rating agencies will need to review if the loan workout would take a longer time because of the lock down measures. Longer foreclosure time will lead to higher credit enhancement requirements for RMBS going forward.

Credit rating agencies also need to re-visit the reporting of the asset performance in the first half of 2020, to check if there is a delay in the number reporting, or in a worst case scenario, a wrong number reporting, which will adversely

affect the effectiveness of the transaction triggers like early amortisation or servicer termination in protecting securitisation bondholders.

Counterparty risks

Counterparty risk is also one of the key factors affecting the securitisation capital structure. Very highly rated transactions usually build in credit enhancement to account for the commingling risk (due to, for example, the servicer disruption) and set-off risk (due to, for instance, the offsetting of the saving deposits against the residential mortgage loans with the same borrower by the bank originator).

The observation of the counterparty performance in China securitisation in 2020 to date did not see a dramatic rating downgrade or operational failure of these main counterparties. However, business disruption did occur due to the government lock down measures. Credit rating agencies need to re-visit the back-up servicer arrangements, to consider if this is really relevant as a counterparty risk mitigant, as the servicer and the back-up servicer could potentially be subject to the same government lockdown measure at the same time. The COVID-19 experience can also be used to re-assess if the credit enhancement built into outstanding securitisations in China is sufficient to account for commingling and set off risks.

Conclusions

COVID-19 is now widely regarded as one of the most earth-shattering events of the 21st century. The resulting global lockdowns and business closures have given rise to notable "black swan events",[38] and a lot of debt forbearance (whether voluntarily or mandatorily imposed) around the world.

As far as the securitisation market is concerned, such forbearance has moved the "goal post" on ABS bond payment and rating models, in a way that was never thought possible.

If the COVID-19 situation continues or escalates, at some stage, it may become necessary for parties of ABS transactions to amend the underlying ABS documents to pass on a back-to-back forbearance to the ABS bond payments and their underlying swap transactions, to avoid a wider catastrophic meltdown in the financial markets.

In the longer term, however, the current stress performance of various securitisation asset classes in Asia (especially China) would serve as a good precedent and indicator, to improve and refine investor protections, credit enhancement requirements, servicing contingency plans, and enhance the reliability of credit rating models. This would enhance investor confidence and raise Asia's securitisation market to new heights post COVID-19.

Note:

The views expressed in this article are the personal views of the authors, and do not necessarily reflect the views of the organisations that they are associated with. We have endeavoured to state the law and the state of play as at June 15, 2020.

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3 "Ambac's fall – And then there was one", The Economist, 4 Nov 2010. Available at: https://www.economist.com/finance-and-economics/2010/11/04/and-then-there-was-one

4 The UNIDROIT Principles is a set of rules for international contracts. These principles are intended to help harmonise international commercial contract law (esp. the gap between common and civil law). In private practice, they offer a neutral contractual regime which are often used in arbitrations.

5 "China issues record number of force majeure certificates", Financial Times, 28 Feb 2020. Available at: https://www.ft.com/content/bca84ad8-5860-11ea-a528-ddof971febbc. Force majeure is defined by the PRC Contract Law (1999), Article 117, as any objective circumstance which is unforeseeable, unavoidable and insurmountable. Article 117 provides that "A party who was unable to perform a contract due to force majeure is exempted from liability in part or in whole in light of the impact of the event of force majeure, except otherwise provided by law."

6 See Singapore Frustrated Contracts Act (Cap. 115), s. 2(1).

7 [1903] 2 KB 740.

8 Some parties in the United States have argued that the Coronavirus pandemic is a 8 force majeure in an attempt to escape contractual liability. However, its applicability remains untested. See: "Coronavirus Request for Cancellation of Contract Due to Force Majeure". Talkov Law. Available at: https://www.talkovlaw.com/coronavirus-cancellation-contract-force-majeure-letter/

9 [2004] 1 HKLRD 754.

10 Grupo Hotelero Urvasco SA v Carey Value Added SL [2013] EWHC 1039 (Comm), a decision of the High Court of England & Wales.

11 On January 26, 2020. See Fitch Ratings, "What Investors Want to Know: Coronavirus Impact on Structured Finance in Asia-Pacific", p. 2, 13 March 2020.

12 "Hong Kong banks to offer relief on mortgages, credit cards, corporate loans as coronavirus outbreak weighs on economy", South China Morning Post, 6 Feb 2020. Available at: https://www.scmp.com/business/banking-finance/article/3049396/hong-kong-banks-offer-relief-mortgages-credit-cards

13 This became effective since 26 March 2020.

14 Defined in Singapore COVID-19 Act, Schedule 1.

15 Singapore COVID-19 Act, s.9(1).

16 Singapore COVID-19 Act, s.5(7).

17 Singapore COVID-19 Act, s.5(3).

18 Singapore COVID-19 Act, s.5(3).

19 Singapore COVID-19 Act, s.6(2) and (4).

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21 "Hong Kong courts set to reopen after coronavirus adjournments", South China Morning Post, 1 May 2020. Available at: https://www.scmp.com/news/hong-kong/politics/article/3082524/hong-kong-courts-setreopen-after-coronavirus-adjournments

22 2002 ISDA Master Agreement, section 5(b)(ii).

23 2002 ISDA Master Agreement, section 5(b)(ii).

24 Under Section 5(a)(i) of the 2002 ISDA Master Agreement.

25 2002 ISDA Master Agreement, section 5(d) suspends all payments and deliveries under any Affected Transaction until the day following the end of the Waiting Period (or until after the event ceases if sooner).

26 Fitch Ratings, "Structured Finance's Forbearance Challenges Go Beyond Liquidity", p. 1, 6 May 2020.

27 Fitch Ratings, "Structured Finance's Forbearance Challenges Go Beyond Liquidity", p. 1, 6 May 2020.

28 Fitch Ratings, "Structured Finance's Forbearance Challenges Go Beyond Liquidity", p. 3, 6 May 2020.

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30 Fitch Ratings, "Coronavirus to Pressure China's Near-Term Auto-ABS Performance", 17 February 2020.

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33 Fitch Ratings, "Default Rate in China Auto ABS Transactions Set to Improve", 2 June 2020.

34 Moody's, "Coronavirus will hurt performance of Chinese structured finance deals", 5 February 2020.

35 Moody's, "Coronavirus disruptions take toll on Chinese auto 35 ABS", 7 April 2020.

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37 Moody's, "Coronavirus fallout is negative for asset performance in consumer loan and credit card ABS", 21 May 2020.

38 See: Kingsley Ong et al, "Black Swan Alert: Oil Price Collapse" (24 April 2020), available at: https://www.eversheds-sutherland.com/global/en/what/articles/index.page?ArticleID=en/global/Hong-Kong/Black_Swan_Alert_Oil_Price_Collapse and Kingsley Ong et al, "Black Swan Alert: Closure of Philippines Stock Exchange and Record Low Base Rates – Impact on Hedging and Financing Documents" (20 March2020), available at: https://www.eversheds-sutherland.com/global/en/what/articles/index.page?ArticleID=en/global/Hong-Kong/Black_Swan_Alert_Closure_of_Philippines_Stock_Exchange_and_Record_Low_Base_Rates

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