Review of Asian securitisations and China's securitisation performance: 18 months into the COVID-19 crisis[1]

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In our previous article published in mid-2020 (in the 11th edition of this book),[4] we considered the potential impact of COVID-19 on asset-backed securitisations in Asia. Eighteen months have now elapsed since the start of the COVID-19 crisis. In this article, we will review some legal updates arising from COVID-19 that could impact asset-backed securitisations ("ABS") in Asia. We will also examine the impact of COVID-19 on ABS issuance volumes in Asia compared to the rest of the world and China securitisation performance in 2020.

Given that China is now the largest and most significant securitisation market in Asia by volume, its ABS performance in this crisis is of particular interest. In our previous article, we predicted that the China securitisation market could actually benefit from the COVID-19 crisis in the longer term.[5] As China emerges from the COVID-19 crisis, it will be interesting to review where we are now.

Legal updates

The majority of cross-border securitisation transactions in Asia are contracted using English law or other common law (such as Hong Kong law or Singapore law) as the governing laws. In our previous article, we discussed the potential use of COVID-19 as an argument for legal forbearance to delay or avoid performance of contractual obligations.[6] These legal concepts include 'frustration', 'force majeure' and 'material adverse effect clauses'. If successfully argued, such forbearance could disrupt cashflows that securitisations rely on, and adversely impact timely payments of ABS bonds.

In the courts in England and the US, there have been some recent test cases on the application of 'frustration' and the use of 'material adverse effect clauses' to avoid contract obligations due to COVID-19.

In *Natixis & Anor v Famfa Oil Ltd* [2020] 2 WLUK 330, the English High Court held that a defence of frustration could


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not be struck out, nor could summary judgment be given in favour of the claimants in relation to it. However, it is worth noting that the alleged frustration in this case arose from certain political issues rather than COVID-19.

In *Salam Air SAOC v Latam Airlines Group SA* [2020] EWHC 2414 (Comm), the English High Court held that the effects of COVID-19 were insufficient to frustrate aircraft leases. In that case, the English Court refused to grant an injunction to stop Latam Airlines from demanding payments under three standby letters of credit that were intended to secure aircraft rental payments owed by Salam Air to Latam Airlines.

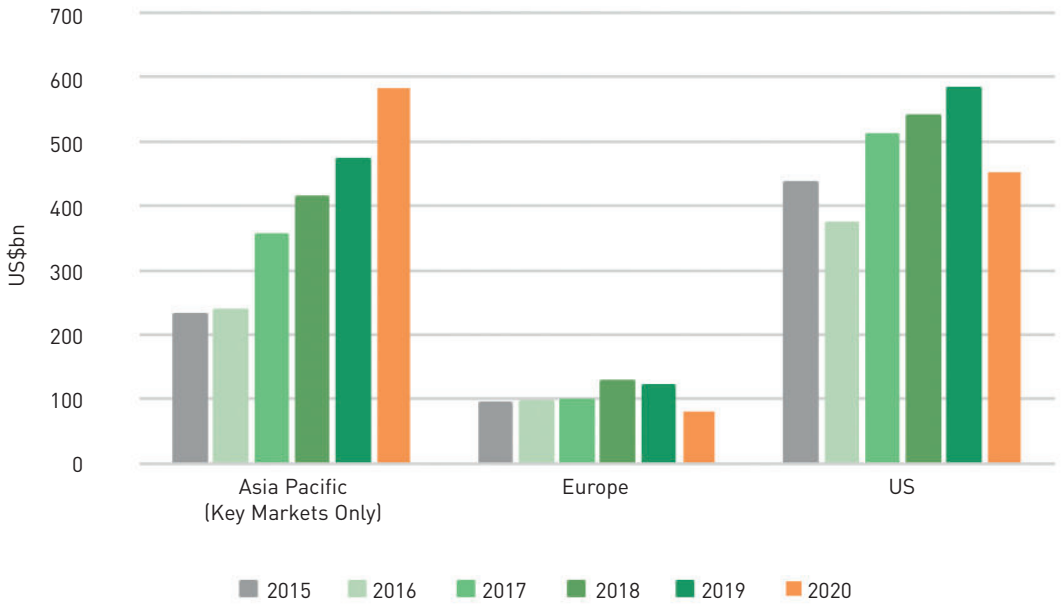
The English court in Salam Air case adopted the stringent multi-factors approach established in *Edwinton Commercial Corporation v Tsavliris Russ (Worldwide Salvage and Towage) Ltd (The Sea Angel)* [2007] 1 CLC 876). Relevant factors include "*the terms of the contract itself, its matrix or context, the parties' knowledge, expectations, assumptions and contemplations, in particular as to risk, as at the time of the contract, at any rate so far as these can be ascribed mutually and objectively, and then the nature of the supervening event, and the parties' reasonable and objectively ascertainable calculations as to the possibilities of future performance in the new circumstances*".

COVID-19 has also been used to invoke material adverse effect claims in the US. In the case of *Snow Phipps Group LLC v KCAKE Acquisition, Inc.* (2020-0282-KSJM), the US Delaware Court rejected a buyer's argument that COVID-19 was reasonably expected to cause a sales decline that would mature into a material adverse effect.

The above cases demonstrate that the courts continue to set a high bar for anyone seeking to use COVID-19 to avoid contractual obligations, in order to protect certainty of contracts, which is essential for commerce.

However, at the time of writing, it is worth nothing that some

ABS issuance volume worldwide **Exhibit 1**



Source: S&P Global, Korean FSS

Asian jurisdictions continue to impose mandatory standstill of contractual obligations.[7] Notably, in April 2021, Singapore decided to continue extending standstill on certain contractual obligations until September 30, 2021. Among other things, businesses involved in construction and supply contracts may continue to avoid payments of liquidated damages for their inability to perform contractual obligations due to COVID 19. Such standstill laws serve as a reminder that the COVID-19 crisis is not yet over.

ABS issuance volumes

Exhibit 1 is a comparison of ABS issuance volume worldwide from 2015-20.

A few observations are worth making here:

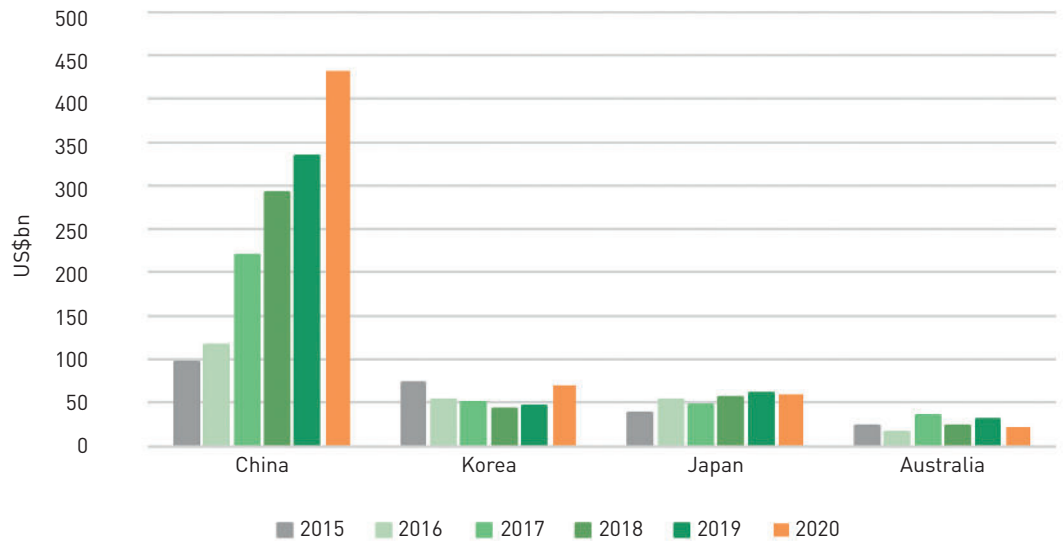
- Historically, the US has been by far the largest securitisation market in the world.
- COVID-19 has adversely impacted US and European securitisation issuance volumes. This can be seen from the fall of issuance volumes between 2019-20 in US and Europe.
- The Asia Pacific securitisation market is now approximately five times bigger than the European securitisation market.
- While the US still remains the largest national securitisation market in the world, in 2020, the combined Asia Pacific ABS issuance volumes overtook the US.

Exhibit 2 provides a breakdown comparison of ABS issuance volumes across the four most active Asian jurisdictions for ABS issuances between 2015-20.

It is interesting to note that the ABS issuance volumes of China and Korea have continued to grow despite COVID-19.

The most remarkable observation from Exhibit 2 is the exponential rise of the China securitisation market. The phenomenal rise of Asia Pacific's ABS issuance volume has been largely driven by the rise of the China securitisation

ABS issuance volume in Asia Pacific **Exhibit 2**



Source: S&P Global, Korean FSS

market. Measured by the issuance volume, the China securitisation market is now on par with the US.

China securitisation has become increasingly important – not just to China's domestic bond market, but also the global securitisation market. We believe China's influence will continue to grow. Given the significance of China, we shall examine the impact of COVID-19 on various major securitisation asset classes in China.

Impact of COVID-19 on China's securitisation performance

Both the new issuances and outstanding issuances have been increasing in China, and the asset types are diversified across consumer asset-backed securities ("consumer ABS") comprising consumer loan, credit card and auto loan receivables, collateralised loan obligations ("CLO") and residential mortgage backed securities ("RMBS").

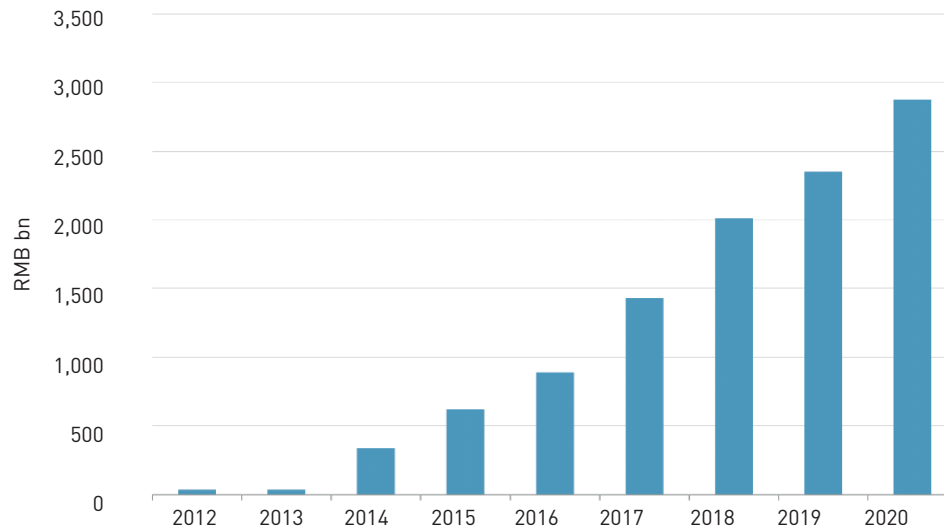
Exhibit 3 shows China's total securitisation issuance volume.

Exhibit 4 shows the securitisation issuance volumes across various asset classes in China.

While the total new issuance of RMBS (residential mortgage-backed securitisation) has been dropping since 2018, RMBS is still the most important asset class in China's securitisation market, driven largely by the repeated issuance from the two major RMBS sponsors, namely China Construction Bank (CCB) and Industrial and Commercial Bank of China (ICBC).

We have previously noted, based on the first half of 2020, that the impact of COVID-19 on the performance of various asset classes in China's securitisation market has varied differently.[8] 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 the RMBS, compared to the other ABS asset classes like consumer and auto loans.

China's total securitisation issuance volume **Exhibit 3**



Source: S&P's China Securitization Performance Watch, February 10, 2021

Data on the second half of 2020 showed that the COVID-19 impact on China's securitisation performance has become less significant, as the delinquency rates of most securitisation transactions dropped from those in the first half and have stabilised since then.[9] China's successful measures in controlling the COVID-19 spread in the country allowed its economic growth to rebound strongly in the second half of 2020, bringing its 2020 economic growth to 2.3%, with potential much higher growth in 2021 onwards. This strongly supports the transaction performance in the near future.

China consumer loan ABS

Consumer loan ABS is one form of securitisation originated by consumer finance companies and backed by unsecured consumer loans. There is no collateral backing the underlying consumer loan receivables.

Exhibit 5 shows the delinquency rates of China's consumer loan ABS from December 2015 to October 2020.

The delinquency rates of consumer loan ABS experienced a spike in the first four months of 2020 and deteriorated much more than the auto loan ABS and RMBS, largely due to the non-secured nature of the underlying receivables and the generally weaker obligor credit profiles. The delinquency rates of the consumer loan ABS associated with the non-bank sponsors are much higher than those of the consumer loan ABS associated with the bank sponsors.

China auto loan ABS

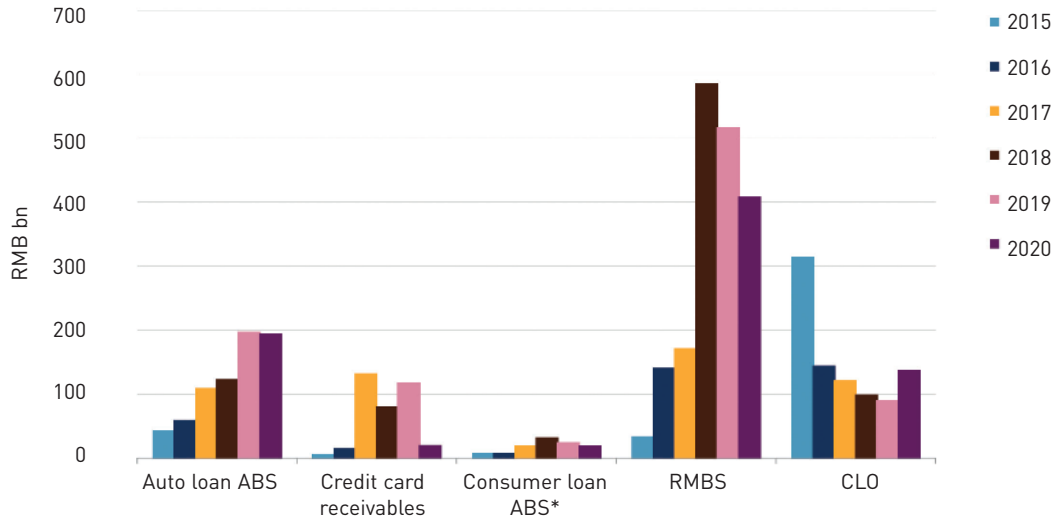
Auto loan ABS is one form of securitisation originated by auto finance companies and backed by auto loans. There are collaterals backing the underlying auto loan receivables.

Exhibit 6 shows the delinquency rates of China's auto loan ABS from July 2014 to October 2020.

The delinquency rates of the auto loan ABS experienced a spike in the first quarter of 2020 but are much lower than those of the consumer loan ABS, due to the down-payment requirements and short tenors of the underlying receivables. Since the start of the second quarter, the auto loan ABS delinquency rates have substantially dropped to the pre-COVID level and stabilised since then.

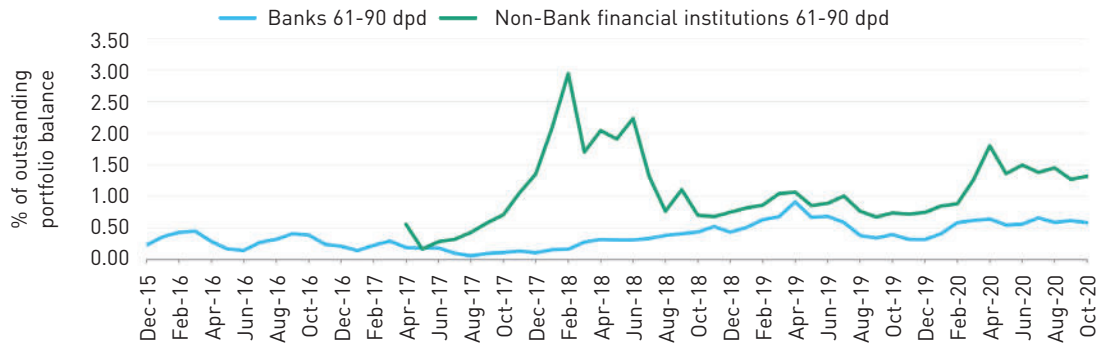
In ABS credit analysis, default rates, payment rates and

Securitisation issuance volumes across asset classes in China **Exhibit 4**



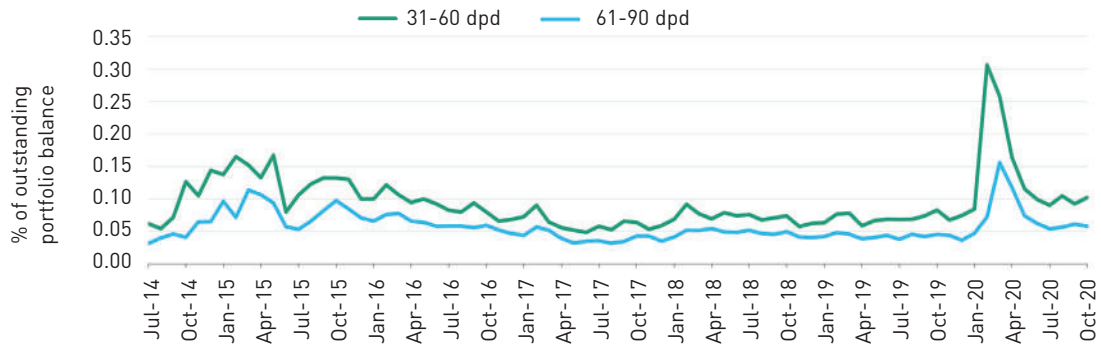
Source: S&P's China Securitization Performance Watch, February 10, 2021

Delinquency rates of China's consumer loan ABS **Exhibit 5**



Source: Moody's China Structured Finance Outlook, December 2, 2020

Delinquency rates of China's auto loan ABS **Exhibit 6**



Source: Moody's China Structured Finance Outlook, December 2, 2020

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. In 2020, this factor was impacted more severely than the other factors. Hence, in rating ABS including the surveillance of the currently outstanding ABS, credit rating agencies need to continue re-visiting their base case default rate assumptions and decide if this is able to cover any future delinquency rate spikes.

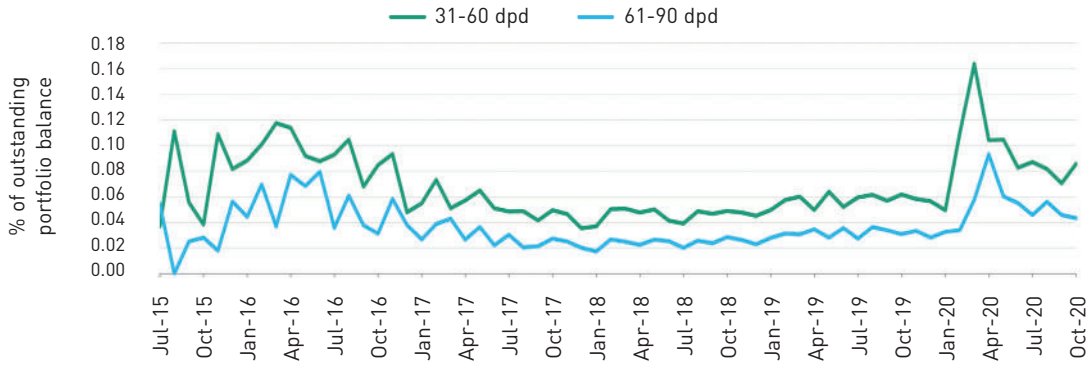
China RMBS

RMBS (residential mortgage-backed securitisation) is a form of securitisation originated by banks and backed by residential mortgage loans. Compared with the other ABS, the underlying assets have residential properties as collaterals.

Exhibit 7 shows the delinquency rates of China's RMBS from July 2015 to October 2020.

The delinquency rates of the RMBS experienced a spike in the first quarter of 2020 but are much lower than those of the other ABS asset classes. Since the start of the second quarter,

Delinquency rates of China's RMBS **Exhibit 7**



Source: Moody's China Structured Finance Outlook, December 2, 2020

the RMBS delinquency rates have substantially dropped and stabilised at slightly a higher level than the pre-COVID. This solid performance reflects the secured nature (residential property collateral) of the underlying receivables.

In RMBS credit analysis, default probability and market value declines are the main drivers for the capital structures. This asset class' performance in 2020 was still solid, as the residential mortgage loan borrowers are still willing to pay, and residential property prices have remained stable. However, rating agencies may need to make use of the underlying defaulted mortgage loan cases to see if the assumed loan workout period is long enough and potentially adjust the loan workout period assumption in future RMBS.

Counterparty risks

Counterparty risk is 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).

Counterparty performance in China securitisations in 2020 did not see a dramatic rating downgrade or operational failure of these main counterparties, though business disruption did occur due to the government lock down measures in the first half of 2020. The COVID-19 experience also shows that the credit enhancement built into the outstanding securitisations in China was sufficient to account for commingling and set off risks.

Conclusion

As we have noted previously, the COVID-19 stress on performance of various securitisation asset classes in Asia will enhance investor confidence and prove beneficial for Asian securitisation in the longer term.[10]

The COVID-19 performance is a good test of the ability of China securitisations to withstand asset performance deterioration and transaction counterparty risks. The experience so far shows that the capital structures of such transactions are sufficient to withstand the asset default and hence protect the senior bondholders. This will help attract more investors to seriously consider investing in this asset class in the future, in view of the higher default cases in China's corporate bond market.

While the COVID-19 crisis is not yet over, we are excited about the future of securitisations in Asia (especially China securitisations).

Notes:

[1] We have endeavoured to reflect the law and state of play as at June 1, 2021.

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[4] "The impact of COVID-19 on asset-backed securitisations in Asia" (Chapter 7), published in the 11th edition of *The Securitisation & Structured Finance Handbook*.

[5] Page 42 in our previous article, "The impact of COVID-19 on asset-backed securitisations in Asia" (Chapter 7), published in the 11th edition of *The Securitisation & Structured Finance Handbook*.

[6] Page 37-38 in our previous article, "The impact of COVID-19 on asset-backed securitisations in Asia" (Chapter 7), published in the 11th edition of *The Securitisation & Structured Finance Handbook*.

[7] E.g. Singapore COVID 19 (Temporary Measures) Act 2020.

[8] See page 41 of our earlier article, "The impact of COVID-19 on asset-backed securitisations in Asia" (Chapter 7), published in the 11th edition of *The Securitisation & Structured Finance Handbook*.

[9] See the individual charts for each asset class.

[10] See page 42 of our earlier article, "The impact of COVID-19 on asset-backed securitisations in Asia" (Chapter 7), published in the 11th edition of *The Securitisation & Structured Finance Handbook*.

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