

COVID-19 Impact on Asset-Backed Securitization Transactions

The recent COVID-19 pandemic is expected to have a significant impact on the financial market and financial transactions, including asset-backed securitization transactions (“ABS Transactions”). This newsletter aims provide you with an overview of the issues relating to ABS Transactions resulting from the COVID-19 pandemic.

As ABS Transactions usually involve the execution of a large number of complex contracts by multiple parties, we believe it is important to assess the potential impact of COVID-19 on such transactions in advance to prepare for the inevitable changes and challenges that the market will face.

I. Securitization of Present Receivables

- The Korean government has announced “Guidelines for the Deferment of Loans and Deferment of Interest Payments” (the “Loan Deferment Guidelines”), which will be effective from April 1 to September 30 of 2020. The Loan Deferment Guidelines are aimed at reducing the economic burden on small to mid-sized companies and small business owners due to COVID-19. Specifically, the guidelines require financial companies to

extend the maturity of loans, including amortized loans and lease obligations¹, as well as the payment of interests for at least six months, provided that the obligor is a small to mid-sized company or a small business owner that has suffered direct or indirect financial loss caused by COVID-19 and has no history of late payments or other non-performance of obligations.

- According to the Loan Deferment Guidelines, it is not necessary to grant a deferment with respect to amortized loans or lease obligations if such indebtedness has been included in the underlying assets of a previous ABS Transaction. However, financial companies may nevertheless decide to grant voluntary deferments in such cases (“Voluntary Deferments”) following a legal review of the matter and in compliance with applicable procedures, such as obtaining the consent of requisite parties involved.
- If a financial company which is an originator of an ABS Transaction wishes to grant a Voluntary Deferment, it must first confirm that the deferment is permitted under the relevant ABS Transaction documents. For an amendment, it is typical for agreements that govern the ABS Transaction to require the consent of the relevant parties including the trustee, securitization vehicle and the controlling beneficiary, and obtaining such consent is not always simple. If the ABS Transaction documents contain comprehensive warranty provisions, the originator may consider using such provision with respect to the deferment of the relevant receivables. In this case, the deferment itself may give rise to a warranty obligation, the performance of which would remove such receivables from the securitized asset pool of the relevant ABS Transaction. However, please note that the financial authorities may disapprove of such transaction, if volume of such repurchase of securitized assets by way of warranty performance is large enough to effectively result in the originator of the asset repaying the asset-backed securities.
- A Voluntary Deferment may also give rise to uncertainty regarding the final repayment of the relevant asset-backed securities, because the delay in payments caused by the Voluntary Deferment will negatively affect cash flow that constitutes the source of repayment of the asset-backed securities. As discussed below, it may be possible to resolve cash flow issues by entrusting additional assets. However, if this is not permitted under the ABS Transaction documents, amendments to the ABS Transaction documents and an amendment registration of the asset securitization plan will need to be made, which, in each case, would require the consent of the relevant parties.

1. The following types of indebtedness are not subject to the Loan Deferment Guidelines, notwithstanding that such indebtedness may constitute amortized loans or lease obligations: (i) household loans, (ii) loans and amortized lease financial products for the purchase of automobiles, (iii) operating leases (including financial leases) that incur further losses to specialized credit financial companies due to the decrease in value of the underlying asset, which is returned to the company by the client after termination of the lease term and (iv) partially deferred amortized loans. .

II. Securitization of Future Receivables

- With respect to ABS Transactions in which the underlying assets are future receivables, it is common practice to set a performance trigger as an indicator for the collection rate in order to protect investors and mitigate risks associated with the creation of the receivables and collection amount (a “Performance Trigger”). The terms of a Performance Trigger depends on the nature of the securitized receivables, and a Performance Trigger is usually followed by the suspension of cash releases to the originator, required entrustment of additional assets and the implementation of other credit support measures, such as commencement of early amortization.
- If a prolonged COVID-19 pandemic results in constant decrease in collection rates for securitized receivables, a Performance Trigger may take effect, leading to the implementation of the credit support measures discussed above. In particular, if cash release is suspended or early amortization commences, the liquidity risk of the originator will increase, and this may negatively impact the credit rating of the originator and the asset-backed securities. It would therefore be advisable to prevent a Performance Trigger through various measures including the additional entrustment of assets or cure of the cause of the Performance Trigger through mutual agreement with the relevant parties.
- One challenge regarding the strategy of entrusting additional assets is that, while it is important that the additional assets be substantially similar to the existing securitized assets already entrusted, it is not always possible to find such assets. In addition, if the provisions in the ABS Transaction documents pertaining to additional entrustment have a narrow application, it may be necessary to amend those documents and the asset securitization plan with the consent of the relevant parties including the trustee, securitization vehicle and its administrator, and the note trustee of the asset-backed securities. Obtaining consent from related parties may be particularly difficult if the asset-backed securities were offered publicly.
- The terms of most ABS Transactions contain a credit trigger that applies if the credit ratings of relevant parties, including the originator, trustee and the servicer, fall below a certain threshold. The credit trigger may take effect as the COVID-19 pandemic continues, possibly leading to the substitution of certain involved parties.

III. Impact on New ABS Transactions

- New ABS Transactions will be adversely impacted if the COVID-19 pandemic causes a decline in the creation of receivables that can be included in the pool of securitized assets or a decline in the collection rate of claims in the long term. Further, while the Loan Deferment Guidelines are in effect, new ABS Transactions based on asset-backed securities that are subject to deferment pursuant to the Loan Deferment Guidelines are also expected to be negatively affected.
- New ABS Transactions will most likely be accompanied by stronger requirements placed on the amount of reserves, size of securitized asset pool and credit support measures. Therefore, prior to entering into a new ABS Transaction, it must be assessed whether the introduction of increased credit support measures will be accepted by the financial authorities based on the credit support measures permitted under relevant laws and regulations.

Should you have any questions or comments about the contents of this newsletter, or if we can be otherwise helpful, please do not hesitate to contact us.

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