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Securitisation in the People's Republic of China: moving forward, but challenges still remain

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In the past few years much has been written and discussed about the great potential for the development of a securitisation market in the PRC. However, until 2005 this potential was largely unfulfilled, principally because of the significant legal, regulatory, accounting and tax hurdles that existed in the PRC and the lack of any securitisation-specific legal framework. Since 2005, there have been a number of significant developments, although it is fair to say that the market has not evolved as quickly as many industry participants would have liked.

The year 2005 was highly significant for the development of securitisation in the PRC. This was primarily as a result of the publication in April 2005 of new regulatory measures, the Administration of Pilot Projects for Securitisation of Credit Assets Procedures (the 'pilot measures'), which were a major initiative and represented the joint efforts of the multitude of PRC regulatory authorities that are involved in asset-backed deals in the PRC. The pilot measures were designed to run in parallel with and support to two pilot securitisation schemes (originated by China Construction Bank and China Development Bank), which received approval in March 2005 from the People's Bank of China and which can be viewed as the first PRC deals to attempt genuinely to embrace international standards. Both deals were launched at the end of 2005 after many months of structuring.

When the pilot measures were published it was hoped that this would accelerate the development of the securitisation market in the PRC, with a rush of deals to follow. However, the market did not ignite and some market

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participants felt that the pilot measures may have been a false dawn, and it was not until halfway through 2007 that the second series of pilot deals occurred. Running in parallel with the pilot measures (which are designed specifically for financial institutions) is the customer asset management plan, which gained more prominence in 2005 and 2006, permitting corporates to enter into securitisation-type transactions (although no such transactions of this nature have been issued since 2006). The pilot measures, together with other subsequent supplemental measures and the customer asset management plan, have signalled a growing acceptance of securitisation by PRC regulators. It is crucial that market participants keep up to date on the fast-moving regulatory changes; understanding the regulatory requirements is key to the successful completion of any securitisation-type structure in the PRC.

To understand and put in context the pilot measures and the recent developments in the securitisation market, it is also necessary to understand the legal environment in the PRC prior to their introduction.

Available securitisation structures

In deciding how to structure any securitisation deal, it is necessary to set up an entity that can purchase the underlying assets and borrow funds from investors. This is far from straightforward in the PRC. In essence, the choice has been either a special purpose vehicle (SPV) or a form of trust. The trust structure lends itself more readily to securitisation in the PRC and the introduction of the Trust Law in 2001 initially led to the development of securitisation-type structures in the PRC using a form of trust. The pilot measures have crucially confirmed the role of the trust in PRC securitisations.

Prior to the pilot measures, it was non-performing loan transactions that made use of this trust structure. There have been notable non-performing loan sales by state-owned commercial banks and their related asset management companies. In particular, important and high-profile non-performing loan transactions were originated by China Huarong Asset Management in 2003 and Industrial and Commercial Bank of China in 2004.

The Huarong and Industrial and Commercial Bank of China deals were significant in that they adopted structures similar to securitisation and can be seen as laying the foundations for future securitisations in the PRC. However, any such transactions had to overcome, or at least address in some way, a number of legal issues, including the following:

- whether the transfer of the underlying assets to the trust was by way of true sale or whether the assets could be clawed back in the event of the originator's insolvency;
- whether the underlying assets were freely transferable and whether there is good historical data as to their performance;
- restrictions on the trust company as to the type of instrument it could issue to raise funds to finance the securitisation;
- a lengthy and involved registration process for the transfer of mortgages;
- a lack of clarity as to how to perfect the transfer of the underlying assets to the trust company;
- an unclear insolvency regime;
- a lack of certainty as to the creation of security over future property and by way of floating charge;
- a lack of clarity as to enforcing security over domestic assets;
- the absence of uniform tax treatment; and
- uncertainty as to the accounting treatment.

These issues were considered in more detail in the PRC chapter of *Global Securitisation and Structured Finance 2006*, and many have been addressed to a greater or lesser degree in the pilot measures.

SPVs versus trusts

To date, the use of both onshore and offshore SPVs in the PRC in the context of securitisation has been unsuccessful. With respect to onshore SPVs, the PRC regulatory regime is not conducive to the establishment of thinly capitalised companies, and although the revised Company Law (which came into effect on

January 1 2006) relaxed certain restrictions, a number of difficulties remain. Similarly, significant regulatory issues also apply to offshore SPVs (eg, those relating to the transfer of, and the creation of security over, renminbi denominated assets in favour of an overseas entity, as well as foreign exchange considerations), and examples of deals using offshore securitisations are likely to remain comparatively rare, even though there are examples of such securitisations, including:

- the Zhuhai People's Government's securitisation of toll road and vehicle registration receivables in 1996;
- the China Ocean Shipping Company's securitisations of freight receivables in 1997 and 1998; and
- the first cross-border commercial mortgage-backed securities deal, carried out by Dynasty Property, which required specific State Administration of Foreign Exchange approval.

A new era: 2005 onwards

There have been a number of major developments since 2005; this chapter considers the developments and analyses their potential impact on the securitisation market.

Pilot measures

The pilot measures were issued on April 20 2005 and represented a consensus of 10 regulatory authorities in the PRC. They were the first concerted regulatory effort in the PRC to grasp the concept of securitisation and facilitate the execution of this financial product. The pilot measures do not have the same weight as national laws promulgated by the National People's Congress (eg, the Contract Law), but nevertheless they do set the tone for legislative reform in the future.

The pilot measures were designed to run in parallel with the China Construction Bank and the China Development Bank pilot schemes and, at the time, there was hope that there would be a flood of deals in the following year. This did not happen, and it was not until September 2007 that the first deal from China's long-

awaited second batch of pilot projects was priced. This was a Rmb4.38 billion collateralised loan obligation (CLO) originated by Shanghai Pudong Development Bank. The significance of this deal is that it was perceived as re-opening the asset-backed securities market in China after a failed effort by China Development Bank to launch a deal three months earlier. The Shanghai Pudong Development Bank deal was shortly followed (in October 2007) by an ICBC Rmb4.021 billion CLO, backed by 60 corporate loans from 34 borrowers in four provinces.

We shall now look at some of the key features of these pilot measures, and the extent to which they overcome obstacles which previously hindered the development of the securitisation market in the PRC.

Scope of pilot measures

The pilot measures apply only to 'credit assets'. This is not a clearly defined term and it is unclear whether they are intended to cover only simple loan facilities or other receivables such as credit card and lease receivables. There does seem to have been some informal suggestion that credit assets encompass those assets that require risk capital allocation by the originator, but this is not set out in the pilot measures. A further limitation is that the pilot measures apply only to credit assets of banking financial institutions.

Segregation of trust assets

The pilot measures anticipate the use of the special purpose trust structure, as outlined above. One of the key features of the pilot measures is that they recognise that credit assets are trust property, and therefore such assets, once transferred to the trust, are not the assets of the originator, trustee, servicer, custodian or any other transaction party (including on insolvency). Investors' rights are similarly limited to the trust property only, and the pilot measures state that the prospectus should set out the limited recourse nature of the securities. Therefore, this helps the true-sale and bankruptcy-remoteness analysis. However, the pilot measures did not specifically address certain ambiguities and uncertainties that existed in the then existing insolvency regime.

Insolvency regime

The new Enterprise Insolvency Law came into effect on June 1 2007. The Enterprise Insolvency Law unifies the insolvency regimes for both state-owned enterprises and non-state owned enterprises. It is therefore crucial in ensuring consistent application of insolvency principles between different originators, although one area where the new insolvency regime does not provide any guidance is substantive consolidation. The bankruptcy-remote status of the trust is critical to the overall structure of a securitisation from a legal, accounting and rating point of view. Accordingly, it is hoped that further, clearer guidance will be published with regard to when the trust will be deemed to be consolidated with the originator, since the existing, comparatively unclear position can only hurt investor confidence.

Transfer of the credit assets

The pilot measures clarify that a valid assignment of the credit assets can be perfected by making a public announcement (rather than giving individual notice to each debtor). This is a positive move, although it seems to contradict the basic position set out in the Contract Law, which requires individual notice to be given. It is hoped that the approach in the pilot measures will be reinforced in due course with further legislation, and indeed the China Banking Regulatory Commission issued a further circular in February 2008 on this point (although admittedly the position is still not clear). The pilot measures, in line with general international standards, provide that the originator must replace or redeem any credit assets that do not conform with certain specified eligibility criteria. They also state that any ancillary rights (eg, a security interest) will be transferred in addition to the credit assets themselves. However, they do not specifically address whether it is still necessary to re-register interests such as mortgages. Supplemental regulations with respect to mortgage registration have been published to provide further clarity on this issue.

Role of transaction parties

The pilot measures prescribe the identities and functions of the various transaction parties (eg, the trustee, the loan servicer and the custodian). For example, the trustee must be a trust and investment corporation or other institution approved by the China Banking Regulatory Commission, and the custodian (ie, the entity which is required to manage the income generated by the underlying assets) is prohibited from being the same entity as the originator.

The trust beneficiary certificates

The pilot measures clarify what can be issued by the special purpose trust and to whom. Specifically, they envisage the issuance and trading of trust beneficiary certificates on the National Interbank Bond Market (NIBBM), albeit subject in each case to prior approval of the People's Bank of China. They also set out a series of documents to be submitted to the People's Bank of China to obtain such approval (eg, an application report, drafts of the main transaction documents and prospectus, a credit rating report and legal and accounting opinions). The certificates must be renminbi denominated; given the absence of a viable swaps market, in effect this means that any underlying assets to be securitised must also be renminbi denominated. Given that the certificates can be issued only on the NIBBM, investors are therefore limited to members of the NIBBM and other entities registered with the People's Bank of China - this typically covers banks, financial institutions and other approved financial companies. Investment funds and foreign-funded banks have also recently been approved as investors, but it is still unclear whether insurance companies, investment funds and branches of foreign banks can invest accordingly.

Supplementary measures

A number of further supplementary measures have been published since the original pilot measures to clarify and reinforce many of the aspects first anticipated by the pilot measures. For example, these relate to:

- ongoing disclosure obligations with respect to the trust property;
- the accounting treatment of credit assets which are securitised;
- the issuance and trading of the securities issued by the trust to investors;
- the tax analysis, especially with regard to stamp duty, business tax and corporate income tax;
- disclosure requirements, in particular those relating to offering circulars and public announcements;
- the criteria applicable to the trust property; and
- regulations on rating securities.

Customer asset management plan

A structure which has gained more prominence in recent years is the customer asset management plan. This structure, which operates separately from the pilot measures, uses a specific capital market-issuing vehicle and is designed for corporates. It is regulated by the China Securities Regulatory Commission. China United Telecommunications launched a deal backed by rental receivables using this structure in August 2005, which was considered to be the first of its type in the PRC. A number of further transactions using this structure have been completed since that first China United Telecommunications deal (although, as mentioned, such structures do not appear to have been used in the market for the last couple of years); one of the reasons for the earlier increase in customer asset management plan activity was the relatively straightforward and time-efficient approval process, requiring the input of only one regulator. The Chinese authorities have indicated that they are especially supportive of customer asset management plan structures which securitise certain types of asset, namely:

- water and power projects;
- toll road, port and transportation projects;
- municipal infrastructure construction;
- commercial buildings; and
- corporate equipment leases and receivables.

However, this structure is not designed specifically for securitisations, and uncertainties relating to the true sale of the receivables and the bankruptcy remoteness of the issuing vehicle remain, and we will have to wait and see to what extent such structures will continue to be used in the future.

Other recent developments

The market continues to show promising signs. In addition to the Shanghai Pudong Development Bank and ICBC deals mentioned above, two further deals from the second batch of pilot projects launched in December 2007. These were China Construction Bank's Rmb4.16 billion mortgage-backed securitisation and China Industrial Bank's Rmb5.243 billion CLO. Noteworthy about the China Industrial Bank deal, in particular, was the comparatively short timeframe in which the deal was launched, notwithstanding global market conditions. Other notable deals include the GMAC-SAIC Rmb1.993 billion auto loan-backed securitisation in January 2008. This was a first of its kind in terms of the asset class for China and there is no doubting the potential of this asset class – in 2006 China became the world's largest market for new cars after the United States. In January 2008 China Construction Bank priced the first non-performing loan securitisation from a Chinese bank (as opposed to an asset management company). On the regulatory side, there continue to be encouraging developments. One such development was an announcement by the People's Bank of China in December 2007 aimed at enhancing the liquidity of asset-backed securities traded on the National Interbank Bond Market, again demonstrating the importance which the regulatory bodies place on this market.

The development of a synthetic market?

Although technically outside the scope of this chapter, it is nevertheless worth highlighting recent developments in the derivatives market in the PRC. As this market evolves, there are certain to be synthetic deals where exposure to a set of assets is transferred

through a form of embedded derivative, rather than by way of a physical sale of those assets.

One of the most significant recent developments was the release of derivatives regulations in March 2004, allowing financial institutions to conduct derivatives business in the PRC for profit (as opposed to pure hedging) purposes. This has been supported by the 2006 publication by the State Administration of Foreign Exchange of a master agreement for foreign currency swaps and forwards, based on the internationally accepted International Swaps and Derivatives Association version, and including many of its key concepts. In addition, a separate regulatory body under the auspices of the People's Bank of China (the National Association of Financial Markets Institutional Investors) published a new master agreement in October 2007 covering a wider range of derivative products, although it is currently unclear in the market as to how the SAFE master and the National Association of Financial Markets Institutional Investors master should interrelate, and is perhaps an example of how regulatory developments in China are sometimes hindered by the number of regulatory bodies involved.

In 2005 the People's Bank of China permitted local banks to trade in renminbi cross-currency swaps and forwards, and, given the government's commitment to liberalising this industry further, there may in the future be developments which will facilitate a synthetic securitisation market. Derivatives are still comparatively new concepts to PRC banks and so this will take time to evolve; however, structured products are already being sold to PRC institutions (aided by such schemes as the qualified domestic institutional investors scheme, introduced in 2006, and the scope of which was widened in 2007), although it will take longer for PRC banks to actually structure and originate such products themselves.

New regulations coming soon?

A recent noteworthy development was a report in the Shanghai Securities News on March 25 2008 that the pilot schemes may be replaced by a new set of approval measures. It was reported that under the new measures,

the China Banking Regulatory Commission will issue licences to those asset-backed securities issuers that have received its prior approval. Each licensed issuer will then be required only to inform the People's Bank of China of any new issuances, provided that certain minimum requirements are met (eg, rating and disclosure requirements). If implemented, this would be a move towards a more regularised, rules-based approach (rather than the current case-by-case approach), and should facilitate the development of the securitisation market. However, at the time of writing no Chinese regulatory body has made any formal announcement in this regard and so it is difficult to comment more substantively at this stage.

Prospects

Since the advent of the Trust Law and, more specifically, the initial introduction of the pilot measures in 2005 and the customer asset management plan structure, there has been renewed interest and vigour in the PRC securitisation market and an increasing willingness of all market participants to embrace this financial product. This impetus is driven by a number of factors, such as:

- pressure to clean up banks' balance sheets (particularly in light of China's accession to the World Trade Organisation in 2001 and the corresponding need for China to open up its banking sector);
- a need to improve capital adequacy to comply with Basel II standards (Basel II has now broadly been adopted at local level following guidelines issued by the China Banking and Regulatory Commission in February 2007); and
- a huge increase in assets such as residential mortgage loans.

However, progress is still piecemeal, as is often the case with many regulatory developments in China. We have seen the launch in 2005 of the pilot measures, coupled with great expectation, followed by the comparatively slow development of the market since

then. It is the second batch of pilot projects in the second half of 2007 that gives genuine cause for optimism; as more and more industry participants in China become familiar with securitisation as a financing tool, we can safely anticipate a further maturing of the market. The market and the regulatory environment have clearly taken significant strides forward since 2005 and all signs point towards the market developing further in the future notwithstanding current global market uncertainty. Yet, perhaps the most difficult question to answer, as is the case with much involving China, is how quickly this will occur, and opinions differ widely on this subject. However, it is crucial to stay abreast of developments, which can happen with unexpected speed. The current cautious approach of the regulators (in terms of approving only a small number

of pilot deals) is nevertheless understandable, given that the market is still very much in its infancy.

There are still many significant obstacles to be overcome, which can be fully resolved only when a full legislative framework is laid down specifically for securitisation. It is only when a broad, rules-based framework is introduced that a true maturing of the market will occur, and it is to be hoped that this happens sooner rather than later, given the vast pool of potential assets, such as non-performing loans, mortgages and other receivables. In addition, market participants should keep a close eye on the development of the derivatives market, which not only aids the cash market but will lead to an undoubted evolution of a synthetic market alongside the cash market in the not too distant future.