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# ASSET-BACKED SECURITIZATION IN CHINA

*Yuwa Wei*

## I. INTRODUCTION

After years of deliberation, the first Chinese law endorsing asset-backed securitization was finally enacted in 2005.<sup>1</sup> In the same year, the State Council of the People's Republic of China approved two pilot projects organized by the China Construction Bank and the China Development Bank.<sup>2</sup> The Chinese investors have given the two projects their full endorsement by over-subscribing for the project bonds.<sup>3</sup> Before the two pilot projects' launch, agreements on cooperative schemes for securitization businesses were negotiated between Chinese banks and foreign financial institutions.<sup>4</sup> Subsequently, Macquarie Bank of Australia received approval to be the first foreign bank to provide securitization services in China.<sup>5</sup> All signs connote the introduction of a new reform mechanism, and the dawn of a new phase of economic reforms.

The economic reforms in China are at a critical stage. The enterprise reforms have led to the corporatization of previously state-owned enterprises. Most of the newly corporatized enterprises are state-owned or state-controlled companies. These companies have retained their affiliation with the state.

Before the economic reforms, state banks extended a large proportion of "policy loans" to state-owned enterprises and constantly underwrote loss-making enterprises.<sup>6</sup> Consequently, banks were distressed by non-performance loans.<sup>7</sup> One of the goals of corporatizing China's state-owned enterprises – to lessen the burden endured by banks – is a result of being the sole financier of industrial firms. How-

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<sup>1</sup> On 20 April 2005, the People's Bank of China and China Banking Regulatory Commission promulgated the Administrative Measures on Pilot Projects of Credit Assets Securitisation.

<sup>2</sup> See Pacuiké Kaiyi, *Developing China's Financial Market Through Negotiable Securities*, HEXUN, Aug. 3, 2006, available at [http://money.hexun.com/1937\\_1762754A.shtml](http://money.hexun.com/1937_1762754A.shtml).

<sup>3</sup> *Id.*

<sup>4</sup> See YANRONG HONG, *STUDIES OF LEGAL ISSUES CONCERNING ASSET-BACKED SECURITIZATION* 234 (2004).

<sup>5</sup> Macquarie Bank registered the first wholly foreign-owned enterprise dealing with securitization business in China in 2002. See *id.*

<sup>6</sup> See YUWA WEI, *COMPARATIVE CORPORATE GOVERNANCE: A CHINESE PERSPECTIVE* 99-100 (2003).

<sup>7</sup> *Id.*

ever, the corporatization has not improved the state banks' ability to withstand bad loans. Currently, an overwhelming proportion of bank loans still go to state-owned or state-controlled companies with the perception that a considerable amount of the loans are to be non-performing debts.<sup>8</sup> Given the key role of the banking sector in China's economy, finding a reform strategy to reduce the pressure on the banks is a priority. Consequently, asset-backed securitization has been introduced as a new mechanism to combat the bad loan problem plaguing China's banking sector.<sup>9</sup> However, a positive outcome from the new reforms is not guaranteed. Securitization involves complex procedures, and requires significant policy support and an efficient legal framework.

This article examines the law and practice of asset-backed securitization in China. The discussion will be developed in three parts. The first part investigates the nature of asset-backed securitization and its utility. There is a lack of incentives for Chinese banks to promote securitization. Currently, securitization in China is primarily motivated by the desire to eliminate non-performing loans.<sup>10</sup> The second part of this article will analyze China's legal framework for securitization. Although the enactment of the *Administrative Measures on Pilot Projects of Credit Assets Securitisation (Measures)* has brought a legal regime of securitization into existence, the law regulating securitization is far from adequate and efficient. Reforms that adjust and coordinate laws and regulations in the areas of trust, insolvency, accounting, and taxation are anticipated. The final part of this article will address what may be done to ensure the securitization program will resolve China's current and future challenges, and the extent that securitization will impact the reform progress of China's banking sectors.

## II. ASSET-BACKED SECURITIZATION

Asset-backed securitization is the financial technique of converting non-liquid assets into instruments that can be traded freely in the capital market.<sup>11</sup> The process involves the creation of a pool of non-

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<sup>8</sup> See Johnny P. Chen, Non-Performing Loan Securitization in the People's Republic of China 29 (May 2004) (unpublished Honors Thesis, Stanford University), available at [http://www-econ.stanford.edu/academics/Honors\\_Theses/Theses\\_2004/Chen.pdf](http://www-econ.stanford.edu/academics/Honors_Theses/Theses_2004/Chen.pdf).

<sup>9</sup> Xinhua News Press Editor, China Will Launch Pilot Asset Backed Securitization Projects to Handle Non-Performing Loan Problems, available at <http://www.cycl.net>.

<sup>10</sup> See HONG, *supra* note 4, at 223.

<sup>11</sup> See Joseph C. Schenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1374-1375 (1991).

liquid financial assets and the sale of the assets to a specially created investment vehicle. The investment vehicle then issues bonds backed by the assets in the financial market.<sup>12</sup> The investors of such bonds get a regular interest payment during the life of the bonds plus repayment of the full face value of the bonds. The difference between unsecuritized bonds and securitized bonds is that the payments of interest and principal of unsecuritized bonds depends on the financial health or insolvency of the company that has issued the bonds, while payments from securitized bonds depend on the cash flow generated by the asset pool.<sup>13</sup>

Securitization is a less expensive method of raising funds than other fund raising schemes. A common practice used to attract investors is to enhance the credit of securitized securities. Credit enhancement can be achieved both internally and externally by subordinating one or more classes of assets, or by obtaining a letter of credit or a surety bond from a financial institution.<sup>14</sup>

The earliest species of asset-backed securitization was mortgage-backed securitization, initiated by U.S. banks in the 1970s.<sup>15</sup> At the time, the United States required banks to extend a certain percentage of mortgage loans.<sup>16</sup> The long-term nature of mortgage loans placed banks under liquidity pressure. To ease the pressure, the U.S. government established the Government National Mortgage Association (GNMA) to develop and improve asset-backed securitization. In 1970, GNMA issued the first bonds under the scheme of asset-backed securitization.<sup>17</sup> In doing so, banks immediately realized the cash value of non-liquid mortgage loan contracts.

After initial success, the practice of asset-backed securitization developed rapidly to include many other types of financial assets, such as credit card payments, trade receivables, leases, auto loans and stu-

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<sup>12</sup> See JOHN DEACON, *SECURITIZATION: PRINCIPLES, MARKETS AND TERMS* 2 (1998).

<sup>13</sup> See *Preventing Abusive Lending While Preserving Access to Credit: Hearing on Protecting Homeowners Before the Subcomm. on Hous. and Cmty. Opportunity, Subcomm. on Fin. Inst. and Consumer Credit, of the H.R., 108th Cong. 4* (2003) (statement of Cameron L. Cowan, Partner, American Securitization Forum), available at <http://financialservices.house.gov/media/pdf/110503cc.pdf>.

<sup>14</sup> *Id.*

<sup>15</sup> See JOSEPH HU, *BASICS OF MORTGAGE-BACKED SECURITIES* 15-16 (1997); Sunil Gangwani, *Securitization 101*, 3 *SPEAKING OF SECURITIZATION: ACCOUNTING, TAX, REGULATORY AND OTHER DEVELOPMENTS AFFECTING TRANSFERS AND SERVICING OF FINANCIAL INSTITUTIONS* 4-1 (1998), available at <http://www.vinodkothari.com/gangwan2.pdf>.

<sup>16</sup> See BAOZHONG GAO, *INSTITUTIONAL ANALYSIS OF ASSET SECURITIZATION IN CHINA* 41 (2005).

<sup>17</sup> *Id.* at 42.

dent loans.<sup>18</sup> Wall Street's philosophy, regarding asset-backed securities, is that any asset with a stable revenue stream is capable of being securitized.<sup>19</sup> "By the end of September 2004, the balance of American asset-backed securities reached 7.2 trillion U.S. dollars, accounting for 31% of the balance of American bond market."<sup>20</sup>

The perceived benefits of asset-backed securitization include:

- (1) supporting public policy objectives such as broad home ownership and the development of financial markets, especially capital and mortgage markets; (2) addressing regulatory requirements for financial institutions, especially capital adequacy and lending limit requirements applicable to banks; (3) transferring risk, especially in the context of non-performing assets and portfolio diversification; and (4) providing finance.<sup>21</sup>

In addition, asset-backed securitization is an efficient method of increasing the liquidity of banks and accelerating the turnover of credit funds. Furthermore, it enables companies to isolate a high risk project by establishing a special purpose enterprise to transfer risks to a wide range of investors.

Following the example of the U.S., many mature market economies have embraced the practice of securitization.<sup>22</sup> In recent years, securitization has also been utilized in many emerging markets. These countries have endeavored to foster a favorable economic and legal environment for their securitization practice. Their experiences serve as inspiration for China in designing and developing its own legal and economic framework for securitization. China, however, has its own special needs and agenda in introducing the concept and practice of securitization. While asset-backed securitization has primarily been utilized to accelerate liquidity of assets in the United States, in China, the paramount purpose behind employing asset-backed securitization is to rectify the non-performing loans of state banks.<sup>23</sup> Securitization therefore is a key step in the ongoing economic reforms. The success of pilot securitization projects will open up new opportunities to reform China's banking sector and to dispose of the non-performing loans of

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<sup>18</sup> See Chen, *supra* note 8, at 4.

<sup>19</sup> See Tang Ye, *Securitization of Non-Performing Loans May Not Achieve Its Purpose*, available at <http://business.sohu.com/20061023/n245939680.shtml>.

<sup>20</sup> The People's Bank of China, PBC & CBRC Official Answers Questions on the Administrative Rules for Pilot Securitization of Credit Assets, *available at* <http://www.pbc.gov.cn/english/detail.asp?col=6400&ID=552>.

<sup>21</sup> See Douglas Arner, *Emerging Market Economies and Government Promotion of Securitization*, 12 DUKE J. COMP. & INT'L L. 505, 505-06 (2000).

<sup>22</sup> See generally SECURITIZATION (David G. Glennie et al. eds., 1998).

<sup>23</sup> See Ye, *supra* note 19.

state-owned companies. Banks and the market play crucial roles in China's securitization program. Two key questions must be asked: First, to what extent are the banks motivated to promote securitization? Second, will the banks be able to create attractive securitization products for investors? In order to answer these questions, it is necessary to analyze China's banking sector.

The People's Bank of China (PBOC) is China's central bank. It makes and implements monetary policy, oversees the State Administration of Foreign Exchange (SAFE), and formulates foreign-exchange policies.<sup>24</sup> The China Banking Regulatory Commission (CBRC) is responsible for maintaining a safe and sound banking system in China. It regulates and supervises banks, asset management companies, trust and investment companies, as well as other deposit-taking financial institutions.<sup>25</sup> Beneath the PBOC and CBRC are the so called "big four," the four state-owned commercial banks: the Bank of China (BOC), the China Construction Bank (CCB), the Agricultural Bank of China (ABC), and the Industrial and Commercial Bank of China (ICBC). Three policy banks exercise government-directed spending functions: the Agricultural Development Bank of China (ADBC), the China Development Bank (CDB), and the Export-Import Bank of China (Chexim). These banks are responsible for financing economic and trade developments and state-invested projects. Beneath the "big four" are smaller state-owned commercial banks: Bank of Communication, CITIC Industrial Bank, China Everbright Bank, Hua Xia Bank, China Minsheng Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong development bank, and Fujian Industrial Bank.

Years of government-directed lending resulted in the "big four" being left with many non-performing loans. According to a PBOC report, non-performing loans accounted for 21.4% to 26.1% of the total lending of China's four big banks in 2002.<sup>26</sup> The figure is well beyond the ceiling specified in the New Basel Capital Accord.<sup>27</sup> In 1999, four asset management companies were established to transfer the non-performing assets from the banks and to deal with these assets. About RMB 14,000 billion non-performing loans were acquired by the four asset management companies.<sup>28</sup> The problem is further compounded by the failure of the four asset management companies to make signifi-

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<sup>24</sup> The People's Bank of China, Major Responsibilities, <http://www.pbc.gov.cn/english/renhagjianjie/responsibilities.asp> (last visited Mar. 24, 2007).

<sup>25</sup> See STATE COUNCIL, *Administrative Law of the Banking Sector*, sec. 2 (2003).

<sup>26</sup> See GAO, *supra* note 16, at 155.

<sup>27</sup> According to the standards in the document, the ceiling for defaulting loans is below 15%. See BASEL COMMITTEE ON BANKING SUPERVISION, *Consultative Document: The New Basel Capital Accord* (2003), <http://www.bis.org/publ/bcbsca03.pdf>.

<sup>28</sup> See HONG, *supra* note 4, at 223.

cant progress in rectifying the non-performing loans. By the end of the first quarter of 2003, only RMB 715.24 billion was recovered.<sup>29</sup> Recovering the remaining part of non-performing loans will be an even greater challenge.

Hence, the asset management companies wish to repackage non-performing loans into viable assets and sell them off to the investors through securitization. However, such a package is unlikely to be attractive to investors.<sup>30</sup> Many are skeptical of how successful the scheme will be. One way to increase the attractiveness of these packages is to upgrade the credit rating of the package. In doing so, however, the benefits of securitizing the debts are likely to be offset by increased costs on credit enhancement.

Nevertheless, the Chinese government is determined to inaugurate asset-backed securitization, with the disposal of the state banks' non-performing loans as the paramount objective. The government and the banks are quite frank about this intention. Both CBC and CDB have clarified that the aim of launching the two pilot projects is to improve their credibility, raise their asset sufficiency, and limit lending risks.<sup>31</sup> There is a danger that securitization in China may become a single-functioned instrument. Its other utilities, including accelerating asset liquidity and increasing efficiency of asset allocation, could be deemed as secondary, and consequently overlooked.<sup>32</sup> Consequently, securitization in China may be guided by the erroneous belief that any large amount of debt is capable of being securitized.<sup>33</sup> However, China is not the only country placing importance on the introduction of securitization to curtail non-performing loans. In fact, using securitization to control non-performing loans is a popular practice in many countries, particularly within Asia and Latin America.<sup>34</sup> What distinguishes China from other countries is the fact that securitization in China is expected to play an important role in assisting the banking sector reforms. The outcome of the securitization practice will have far reaching influence on China's economic life in the coming years.

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<sup>29</sup> *Id.* at 224.

<sup>30</sup> See also GAO, *supra* note 16, at 163; Xueyin Liu, *Securitization is Not the Best Medicine for Non-Performing Loans* (2005), <http://www.zgjr.com/News/2005929/Bank/918138581100.html>; see generally Xude He, *Securitization of Banks' Non-Performing Loans: Some Analyses and Findings*, 8 FINANCE AND TRADE COMMERCE (2000).

<sup>31</sup> See Ye, *supra* note 19.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> See Sean Bulmer & Hyoung Don Kim, *SECURITIZATION YEARBOOK 2000*, at 29; see also GAO, *supra* note 16, at 165.

Logically speaking, in an emerging market, to boost investors' confidence in securitized products and ensure the success of securitization, it is desirable to first introduce some securitized bonds of low risk and senior security. Mortgage loan business in China has been rapidly expanding. By the end of 2004, the mortgage loans reached RMB 18,100 billion, accounting for more than 10% of the total bank loans.<sup>35</sup> Mortgage loans have a stable cash flow and a high credit rating. Securitization of mortgage loans is therefore able to provide investors with a more attractive financial product. However, the Chinese commercial banks are not very keen to securitize mortgage loans, because mortgage loans have a low default rate, and are thus regarded as safer loans.<sup>36</sup> Furthermore, because investment channels available to Chinese citizens are limited, most citizens elect to deposit their savings in banks. Chinese banks are thus not under substantial liquidity pressure and not particularly motivated to securitize these bundles of well-performing loans.<sup>37</sup> These banks are interested in retaining securitized mortgage loans within their realm by selling securitized mortgage loans to affiliated customers who are usually large state-owned or controlled corporations.<sup>38</sup> In doing so, the banks are able to kill three birds with one stone: increasing asset liquidity, limiting the costs of securitization, and retaining large affiliated customers.<sup>39</sup> The practice reduces securitization to an exercise of exchanging benefits and sharing limited risks among insiders, which in turn undermines the government's reform purposes.

To honor its WTO commitments, China has lifted the restrictions on foreign bank branches conducting full operations of both foreign-currency business and RMB business in the country.<sup>40</sup> Chinese banks are expected to face relentless competition from foreign banks in the very near future. Encumbered by non-performing loans and a low asset sufficiency rate, Chinese banks will have to operate under unprecedented risks. Any strategic mismanagement in the banking sector will expose China's economy to disastrous instability.<sup>41</sup> The

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<sup>35</sup> See Qiaoling Fu, *Government Guided Mortgage Backed Securitization in the US* (2005), available at <http://cn.biz.yahoo.com/061016/16/jg7d.html>.

<sup>36</sup> See HONG, *supra* note 4, at 233; see also News Editor, Standard & Poor's Opinion: Securitization in China Has Great Potential, available at <http://news.xyef.com/102006/13/542490.html>.

<sup>37</sup> *Id.*

<sup>38</sup> See Ye, *supra* note 19.

<sup>39</sup> *Id.*

<sup>40</sup> See Michael Overmyer, With China's WTO Entry Requirements Winding Down, Will 2006 Become China's "Year of the Bank"?, CHINA BUS. REV. ONLINE, available at <http://www.chinabusinessreview.com/public/0601/overmyer.htm>.

<sup>41</sup> See Chen, Weitseng, *WTO: Time's Up for Chinese Banks—China's Banking Reform and Non-Performing Loan Disposal*, 7 Chi. J. Int'l. L. 239, 241 (2006).



Chinese policy makers have foreseen the threat and are determined to tackle non-performing loans on a massive scale.<sup>42</sup> Unfortunately, Chinese banks and state controlled companies are not so mobilized. There is a concern that securitization may be reduced to another stopgap measure, which will only temporarily give relief to the state banks and state controlled companies.<sup>43</sup>

In summary, the mechanism of securitization in China must be adjusted to suit China's special economic reform purposes – unbundling state banks on the one hand, and withstanding the lure of distorted practice on the other. The result of the reforms will not be immediately obvious. It will take time to ascertain if the new reform strategy can satisfactorily deliver the desired outcomes.

### III. CHINA'S LEGAL FRAMEWORK SUPPORTING ASSET-BACKED SECURITIZATION

Securitization demands the backing of a sophisticated legal framework. It involves tailoring the conventional trust law, insolvency law, corporate law, taxation law, securities law, contract law, and accounting rules to suit the specific purpose of securitization, in addition to implementing other special laws on securitization. This is because, although securitization has “unique functions and advantages, it also has quite a few latent risk factors such as, liability violation, force majeure, payment in advance, deterioration of economic conditions, and changes of interest rates.”<sup>44</sup> Therefore, a legal infrastructure sustaining a systematic approach to risk evaluation, mortgage foreclosure, compulsory insurance, credit enhancement, and insolvency resolution, is required. Common law jurisdictions enjoy special advantages due to the nature of their legal systems. The flexibility of the case law, the existing equitable doctrines, and trust and fiduciary duties, all aid the practice of securitization.<sup>45</sup> By contrast, the “securitization structure has presented problems in civil law based countries, where the concept of trust law has traditionally not existed.”<sup>46</sup> These countries have to enact special legislation to accommodate securitiza-

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<sup>42</sup> See *id.* at 247; Patricia Costa, C. Tyler Curtis & Jay R. Field, *An Analysis of the Chinese Banking Sector Post WTO Accession*, 9-10 (2006), available at [http://www.umich.edu/~ipolicy/china/2\)%20An%20Analysis%20of%20the%20Chinese%20Banking%20Sector,%20Post%20WTO%20Acces.pdf](http://www.umich.edu/~ipolicy/china/2)%20An%20Analysis%20of%20the%20Chinese%20Banking%20Sector,%20Post%20WTO%20Acces.pdf).

<sup>43</sup> See Ye, *supra* note 19.

<sup>44</sup> See Shanghai Far East Credit Rating Co., Ltd, *The New Trend of Housing Financing Regime Innovation in China—The Securitization of Housing-Mortgaged Loans*, <http://www.fareast-cr.com/ydzxe/jcyj/jcyj.htm> (last visited Mar. 5, 2007).

<sup>45</sup> See HONG, *supra* note 4, at 35-36.

<sup>46</sup> See Timothy C. Leixner, *Securitization of Financial Assets*, available at <http://www.hklaw.com/Publications/OtherPublication.asp?ArticleID=41>.

tion including adopting “legislation to permit the limited use of trusts (Argentina and Brazil) or [creating] special purpose corporations to serve the same purpose (France).”<sup>47</sup> In addition, there is “a lack of experienced underwriters, trustees and attorneys” in civil law countries.<sup>48</sup> Consequently, securitization in civil law countries, including mature markets, is underdeveloped in comparison to common law countries.<sup>49</sup>

China is a civil law country, and presently, a country thriving more on practice than on law.<sup>50</sup> Developing a favourable legal environment therefore, is a crucial step if securitization is going to be successfully implemented.<sup>51</sup> China has made a good start in creating a legal framework for securitization. Since April 2005, China has enacted the *Administrative Measures on Pilot Projects of Credit Assets Securitisation* (promulgated by the PBOC and the CBRC), the *Provisions on Accounting Rules for Pilot Projects of Credit Assets Securitisation* (Promulgated by the Ministry of Finance), the *Rules for the Information Disclosure of Asset Backed Securitization* (promulgated by BPOC), and the *Regulatory Measures on Financial Institutions Undertaking Credit Assets Securitization* (promulgated by CBRC).<sup>52</sup> The above regulations provide answers to fundamental questions relating to how the securitization scheme will work in China. However, more efforts are required in order to develop a mature legal regime for securitization. The enacted regulations have clarified the following important issues:

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<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> See GAO, *supra* note 16, at 13.

<sup>50</sup> See Vinod Kothari, *Will China Remain Limited to NPL Securitizations, Even as Massive Opportunities Knock at the Door?*, available at [http://www.vinodkothari.com/secnews\\_804.htm#china\\_secuitisation](http://www.vinodkothari.com/secnews_804.htm#china_secuitisation).

<sup>51</sup> Nicholas J. Faleris, *Cross-Border Securitized Transactions: The Missing Link in Establishing a Viable Chinese Securitization Market*, 26 *Nw. J. INT'L L. & BUS.* 201, 206-09 (2005).

<sup>52</sup> PEOPLE'S BANK OF CHINA – CHINA BANKING REGULATORY COMMISSION, *Administrative Measures on Pilot Projects of Credit Assets Securitisation*, Announcement No. 7 (2005); *Provisions on Accounting Rules for Pilot Projects of Credit Assets Securitisation*, May 16, 2005; PEOPLE'S BANK OF CHINA – CHINA BANKING REGULATORY COMMISSION, *Rules for the Information Disclosure of Asset Backed Securitization*, Announcement No. 14 (2005); *Regulatory Measures on Financial Institutions Undertaking Credit Assets Securitization*, November 7, 2005.

• **Who can be the originator of asset-backed securitization?**

The newly enacted law clarifies that only financial institutions can securitize their assets.<sup>53</sup> It is therefore more appropriate to address an SPV special purpose trust (SPT). The trustee may be an investment and trust company or a trust institution approved by the CBRC.<sup>54</sup> Other forms of business structures are not permitted to become an SPV.

By contrast, in the United States, an SPV can take the form of a limited liability company newly created for a specific purpose, a trust, or an existing corporation.<sup>55</sup> Although Chinese securitization law does not expressly prohibit a company from becoming an SPV; the current requirements in the Chinese *Company Law* prevent it. According to the *Company Law*, a limited liability company should have at least RMB 30,000 registered capital, and a joint stock company must have at least RMB 5,000,000.<sup>56</sup> Chinese law also stipulates that the issuance of debentures or bonds requires the net assets of a limited liability company be at least RMB 60,000,000, while the cumulative value of debentures or bonds must not exceed 40% of the company's net assets.<sup>57</sup> Such a high threshold simply forbids companies from acting as an SPV. Unless the *Company Law* is modified, any inquiry into the feasibility or rationality of allowing companies to act as SPVs would be inconsequential.

• **Will securitized assets be subject to credit rating, and how should credit enhancement be achieved?**

In the United States, all asset-backed securitizations are rated by an independent rating agency. Rating agencies are private companies that assess the risks associated with the full and timely payment of the debt securities.<sup>58</sup> In securitizations, the rating agencies play an even more active role by assisting in structuring the transaction. For instance, they may require structural changes, dictate some of the required arrangements, and mandate changes in servicing procedures.<sup>59</sup>

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<sup>53</sup> See PEOPLE'S BANK OF CHINA – CHINA BANKING REGULATORY COMMISSION, *Administrative Measures on Pilot Projects of Credit Assets Securitisation*, Announcement No. 7, art. 2 (2005).

<sup>54</sup> *Id.* at art. 16.

<sup>55</sup> Jian Wang, *What China Can Learn from US Securitization*, INT'L FIN. L. REV., Jan. 2006, 2, available at <http://www.cadwalader.com/assets/article/010106IFLRWang.pdf>.

<sup>56</sup> *Company Law* (P.R.C.) (promulgated by Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), arts. 26, 81.

<sup>57</sup> Wang, *supra* note 55, at 3.

<sup>58</sup> See Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 6.

<sup>59</sup> See Leixner, *supra* note 46, at 4.

They also help the SPV to determine the “optimal credit enhancement levels” for the securitized securities.<sup>60</sup> Investors make investment decisions by relying on the rating given by the rating agency, and also by reference to the reputation of the rating agency.<sup>61</sup> A high rating means a low credit risk to investors. Highly rated securities are thus more attractive to investors, even when they pay a lower interest rate on the securities.<sup>62</sup>

Chinese law has incorporated the practice of credit ratings and credit enhancement. Article 35 of the *Administrative Rules for Pilot Securitization of Credit Assets* states that securitized assets are subject to mandatory and continuous credit rating. Article 34 stipulates that the credit rating of asset-backed securities may be enhanced through internal or external credit enhancement.

• **How can the SPT’s insolvency/bankruptcy remoteness be achieved?**

Recognition of the insolvency-remote nature of the SPV (in China’s case, the SPT) is fundamental in any form of securitization. The insolvency remoteness is achieved by “true sale,” where the assets transferred to the SPV/SPT from the originator are viewed as a sale.<sup>63</sup> In other words, arrangements should be made to ensure that the assets are protected from the claims of creditors of the originator in the event of insolvency.

Chinese law has shifted to facilitate the concepts of true sale and insolvency remoteness of the SPT. This is made possible by the creation of a trust deed between the originator and the trustee. The trust deed must specify certain matters including, the purpose of the trust, the rights and obligations of the originator and the trustee, the means by which the beneficiaries obtain their trust benefits, and the scope, type, criteria and status of the trust assets.<sup>64</sup> The law has introduced a double guaranteeing mechanism of true sale – the buyback provision in the trust contract. If the assets transferred to the trust do not conform to the trust deed in terms of scope, type, standards or status as agreed in the trust deed, the trustee may require the originator

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<sup>60</sup> Sunil Ganwani, *MBS Structuring: Concepts and Techniques*, SECURITIZATION CONDUIT, 1998, at 26, available at <http://www.vinodkothari.com/gangwani.pdf>.

<sup>61</sup> The highest-reputation rating agencies are Standard & Poor’s Ratings Services, Moody’s Investors Service, Inc., and Fitch Investors Service, Inc. Schwarcz, *supra* note 61, at 6-7.

<sup>62</sup> *Id.* at 8.

<sup>63</sup> See Cowan, *supra* note 13, at 4.

<sup>64</sup> Administrative Rules for Pilot Securitization of Credit Assets (jointly promulgated by the People’s Bank of China and the China Banking Regulatory Commission), Apr. 20, 2005, art. 13 (P.R.C.).

to buy back or replace the underlying credit assets.<sup>65</sup> Furthermore, the *Administrative Measures on Pilot Projects of Credit Assets Securitisation* requires the assets transferred to the trust from the originator be independent of the originator, the trustee, the loan servicers, the fund custodians, securities registration and depository institutions and other institutions rendering services for securitization transactions.<sup>66</sup>

• **Who are the investors or beneficiaries of the SPT?**

The law specifies that investors or beneficiaries of the SPT must be institutional investors.<sup>67</sup> However, the law itself does not define institutional investors. Readers may understand the term according to its ordinary meaning or usage in business and commerce.

An asset-backed securitization requires a number of steps. First, the originator should create a pool of credit assets and set up a SPT.<sup>68</sup> Second, the credit assets must be transferred into the SPT and the trustee should be appointed, which is usually a trust and investment company.<sup>69</sup> Third, a trust contract should be executed between the originator and the trustee, specifying the rights and obligations of both parties, the trust terms, the method of managing the credit assets, and the form and means whereby the beneficiaries are to receive the benefits from the trust.<sup>70</sup> Fourth, the trustee offers asset-backed securities in the form of trust beneficiary certificates to institutional investors. The PBOC will then, with reference to the law, the credit rating report, the accounting opinion, and the legal opinion, determine whether the trustee may offer the asset-backed securities on the national inter-bank bond market.<sup>71</sup> Fifth, the income generated by the assets will be used to pay returns on the asset-backed securities.<sup>72</sup> This whole process should be under the supervision of the CBRC.<sup>73</sup>

Although the recent legislative efforts represent a breakthrough in securitization law-making, certain ambiguities remain in the law.

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<sup>65</sup> *Id.* at art. 14.

<sup>66</sup> *Id.* at art. 6.

<sup>67</sup> See *Regulatory Measures on Financial Institutions Undertaking Credit Assets Securitization*, *supra* note 55, at arts. 3, 13; see also *Administrative Measures on Pilot Projects of Credit Assets Securitization*, *supra* note 55, at art. 2.

<sup>68</sup> See *Administrative Measures on Pilot Projects of Credit Assets Securitization*, *supra* note 52, at art. 2.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at arts. 2, 13.

<sup>71</sup> *Id.* at art. 3.

<sup>72</sup> *Id.* at art. 2.

<sup>73</sup> *Id.* at art. 7.

- **Who is responsible for the credit rating?**

The law states that credit ratings should be completed by credit rating institutions with rating qualifications.<sup>74</sup> The law also requires credit rating institutions to ensure fairness and objectivity in credit rating activities.<sup>75</sup> However, the law does not specify the rating qualifications of credit rating institutions. The only statement touching the issue is in Article 61 of the *Regulatory Measures on Financial Institutions Undertaking Credit Assets Securitization*, which states that the CBRC will take the professional capacity, rating methods, and effects of the rating institution into account when deciding whether the credit rating report can be relied upon in identifying the risks of a securitization transaction. This gap in the law has resulted in some uncertainties.

- **How will the securitization law and the bankruptcy law be reconciled?**

The Chinese securitization law attempts to verify the insolvency and remoteness of the SPT by providing that the assets transferred into such a trust will not be affected by the bankruptcy of the trustee, originator, administrator or other service providers.<sup>76</sup> However, uncertainties still exist due to provisions in the *Bankruptcy Law*. For instance, the *Bankruptcy Law* states that a transaction at an undervaluation by an institution that later becomes insolvent is void if it was entered into six months prior to the court's acceptance of the insolvency petition.<sup>77</sup> Before the issue of pricing securitized assets is further addressed by law, uncertainties associated with the SPT's insolvency remoteness should be rectified.

- **What is the taxation implication?**

The current law refers tax issues to future legislation. Hence, uncertainties remain since future law development has to be taken into account in credit asset-backed securitization.

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<sup>74</sup> *Id.* at art 35.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at art. 6 ("In the event of the liquidation of the originators, trustees, loan servicers, fund custodians, securities registration and depositary institutions and other institutions rendering services for securitization transactions resulting from their dissolution, revocation or bankruptcy under law, the trust assets shall not be included in their liquidated property.")

<sup>77</sup> See Bankruptcy Law of the People's Republic of China, art. 35 (promulgated by the P.R.C. President, Dec 2, 1986) as reprinted in LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 295 (rev. vol. 1983-1986).

- **What is the scope of “credit assets”?**

The term credit assets is not clearly defined. It is uncertain to what extent various types of receivables are included.

In summary, the enactment of securitization laws has received widespread support in China and overseas. Although detailed regulations are needed, the introduction of the legal framework for asset-backed securitization is a very good starting point. Skeptics questioning the outcome of the government’s strategic use of securitization in economic reforms. The law itself, however, has received much less criticism. This indicates the increasing maturity of law-making in China, particularly in the area of commercial law. Nevertheless, the Chinese securitization law is far from complete and mature. Whether the law will lead to an efficient securitization market in China is not yet evident, and the past experiences in China have shown that a good legal system does not necessarily guarantee a successful practice.

#### IV. SECURITIZATION AND THE FUTURE REFORMS OF CHINA’S BANKING SECTOR

To ensure the healthy development of securitization, China needs to nurture a favorable environment for the practice. The experience of mature markets demonstrate that governmental guidance and support are crucial to the success of securitization schemes, particularly at the initial stages. For example, in the U.S., when securitization was at its developmental stage, the government played a key role in promoting securitization. The support was offered mainly in three aspects: institutional, regulatory, and credibility.

- **Institutional support**

In 1934, the U.S. Congress established the Federal Housing Administration (FHA) to provide home loan insurance to private financial institutions. The establishment of the FHA stimulated the home loan business of private financial institutions and reduced the risk of default on home loans.<sup>78</sup> In 1938, the Federal National Mortgage Association (FNMA) was established to foster a secondary market for home mortgages. Its main business was purchasing the pooled home mortgages insured by the FHA in order to supply sufficient capital to the FHA.<sup>79</sup>

In 1968, the FNMA was divided into two institutions, the FNMA and the Government National Mortgage Association (GNMA).<sup>80</sup> After the division, the FNMA became a quasi-government agency, whilst the GNMA remained a government agency performing

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<sup>78</sup> See GAO, *supra* note 16, at 40.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

the functions of the previous FNMA. After the division, the FNMA focused on developing the secondary market for home mortgages, while the GNMA's business was limited to guaranteeing home mortgages.<sup>81</sup>

In 1970, the U.S. government established the Federal Home Loan Mortgage Corporation (FHLMC), a quasi-government agency, engaged in purchasing home mortgages and issuing securitized bonds backed by the home mortgages. The mortgage backed bonds issued and insured by the above agencies enjoyed the highest rating and liquidity on the secondary market of home mortgages.<sup>82</sup> An important reason for this was that such bonds were backed by full faith and credit of either government agencies or quasi-government agencies. These early bonds took the form of single-class mortgage pass throughs.<sup>83</sup> Soon, new species of securitization, including mortgage backed securitization and asset-backed securitization, were introduced.<sup>84</sup>

- **Regulatory Support**

The U.S. government introduced a number of rules and regulatory guidelines to standardize the practice of securitization.<sup>85</sup> As a result, the standardization and efficiency of the securitization market was quickly realized. Without government intervention, the market would have taken much longer to become well-ordered and standardized. The U.S. government also encouraged securitization by introducing favorable taxation and accounting policies, as well as removing legal barriers.<sup>86</sup> With such regulatory support, the securitization market developed robustly.

- **Credibility**

Credibility is the foundation of securitization.<sup>87</sup> The initial success of securitization in the U.S. was largely a result of the government's efforts to enhance the credibility of securitized bonds. In other words, the guarantee and insurance provided by those U.S. govern-

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<sup>81</sup> *Id.* at 4.

<sup>82</sup> Gangwani, *supra* note 15, at 1.

<sup>83</sup> *Id.* at 2.

<sup>84</sup> *Id.*

<sup>85</sup> For instance, Generally Accepted Accounting Principles; Regulatory Accounting Principles; Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Reporting by Transferors for Transfers of Receivables with Recourse; and Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitization, etc.

<sup>86</sup> For example, securitized bonds are treated as non-risk securities and therefore can be freely purchased by financial institutions. The interest is non-taxable or tax deductible.

<sup>87</sup> See Tim Nicolle, *Introduction to Securitization*, <http://www.vinodkothari.com/nicolle.htm>.



ment and quasi-government agencies greatly improved the credibility of the securitized bonds. It also strengthened investors' confidence in the securities, drawing investors to the market.

Other mature markets have followed the same path.<sup>88</sup> The practice in their systems unexceptionally proves that government guidance is essential in promoting securitization. The experiences of these markets provide rich sources from which China can draw inspiration.

China's market economy has evolved from a planned economy, with the government playing the key role in organizing finance and productivity. The Chinese government consistently intervened into economic activities, and thus is in an advantageous position to promote securitization by exerting its intervening power. However, governmental intervention must be carefully oriented and controlled. After all, the object of governmental intervention is to build a securitization market. Once the market comes into existence and gradually grows into maturity, the government should leave the market to be regulated by market rules. Hence governmental intervention should be limited to introducing and enhancing market mechanisms, and building and perfecting the legal infrastructure. At present, the priority of the Chinese government should be to improve the standardization of securitization, accelerate the development of a legal framework, and enhance law enforcement.

China has a specific agenda in securitization. The goal of improve the economic performance and efficiency of its commercial banks by securitizing their non-performing loans. The uniqueness of China's case is that securitization in China is a historic duty of facilitating the country's economic reforms. The economic reforms come at a crucial stage. Corporatization brings new problems, and has not elevated the economic performance of state-owned enterprises to the expected and desired level.<sup>89</sup> The government faces a dilemma of whether to privatize these state-owned enterprises or continue to subsidize them. Massive privatization of industrial firms means social, political and economic instability, as well as losing national industries to foreign predators. However, continuing to subsidize these firms will drag state banks into bankruptcy, which will eventually drive the whole economy into the abyss. Any device that enables the enterprises to find

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<sup>88</sup> Since the 1980s, securitization was introduced in some first world European countries including France, Germany and the UK, as well as some Asian countries and emerging economies including Japan and Korea. The governments of these countries took the initiative in the process. HONG, *supra* note 4, at 39, 277.

<sup>89</sup> See generally H.G. Broadman, China's Membership in the WTO and Enterprise Reform: The Challenges for Accession and Beyond, *available at* [http://papers.ssrn.com/paper.taf?abstract\\_id=223010](http://papers.ssrn.com/paper.taf?abstract_id=223010).

other financial resources, therefore relieving the government of having to choose between the two undesirable alternatives, would be heartily embraced. The development of the stock market is an example.

The development of the stock market in China has, to a certain extent, eased capital shortage suffered by some companies by providing a new channel from which they can raise funds. However, many companies do not benefit from the stock market. The shares of wholly state-owned companies are not tradable.<sup>90</sup> The shares in partly state-owned companies are divided into state shares, legal person shares, and ordinary shares. State shares cannot be traded and legal person shares can only be transferred among legal persons (an incorporated body with an independent personality).<sup>91</sup> Only ordinary shares, accounting for a small portion of the total shares of such companies, are freely transferable.<sup>92</sup> The scarcity of tradable shares results in price distortion on the stock market.<sup>93</sup> Companies regard the stock market as a place where they can enjoy the great liberty of absorbing capital.<sup>94</sup> Instead of enhancing performance, many companies pursue short-term benefits. Violations of listing rules and securities regulations happens frequently, and investors have lost their confidence in the market.<sup>95</sup> The combination of macro and micro economic factors, including price distortion and market irregularities, led the securities market into recession.<sup>96</sup> Since the end of 2001, the market has not been in good shape.<sup>97</sup> With the stock market experiencing years of depression, the pressure on China's commercial banks has remained. The banks continue to lend to industrial firms and to be encumbered by non-performing loans. Securitization seems to be one of the last resorts for tackling this problem.

Unfortunately, it has become clear that China needs to find a solution to its economic problems within the immediate future, since foreign banks will be competing with Chinese banks on equal terms very soon. If securitization is reduced to another method of short-term relief, the consequences could be fatal, since fierce competition will not allow the Chinese to benefit from the use of trial and error tactics, as it has used previously.

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<sup>90</sup> See BAI SAN XIE, CHINA'S SECURITIES MARKET 62.

<sup>91</sup> See CHENG XI YAO, STOCK MARKET AND FUTURES MARKET IN THE PEOPLE'S REPUBLIC OF CHINA 3-37 (1998).

<sup>92</sup> *Id.*

<sup>93</sup> See Yuwa Wei, *Volatility of China's Securities Market and Corporate Governance*, 29 SUFFOLK TRANSNATIONAL L. REV. 224, 224-225; XIE, *supra* note 90, at 62.

<sup>94</sup> See XIE, *supra* note 90, at 197.

<sup>95</sup> See Wei, *supra* note 93, at 214.

<sup>96</sup> *Id.* at 213-14.

<sup>97</sup> *Id.* at 208.

Thus, China needs to utilize the adopted strategy wisely. Securitization should aim at uprooting non-performing loans, not merely securitizing and selling the bad loans accumulated in the past years. It is high time to prevent issuing loans that are likely to turn into non-performing loans. Securitization can be used to achieve this purpose. This is because securitization is a way of breaking off the con-sanguineous relationship between the state banks and the state industrial firms. Once the credit loans are sold to a SPT, securitized, and eventually purchased by investors, industrial firms are under increased pressure to repay the debts or face the real threat of compulsory liquidation.<sup>98</sup> Furthermore, because securitized assets are rated, and their ratings are exposed to the market and investors, banks are under enhanced supervision when making loans. This stimulates Chinese commercial banks to improve their management and governance in order to reduce imprudent lending decisions, which will ultimately reduce the number of non-performing loans.<sup>99</sup>

Some suggest that non-performing loans are not suitable for securitization, since they offer limited inducement to investors. It is also expensive to enhance the credibility of such loans by way of insurance or guarantee. In fact, not all non-performing loans are lost loans. In China, non-performing loans are classified into five categories. Some borrowers may only delay the repayments of loans; they are not necessarily unable to repay the debts permanently.<sup>100</sup> Hence, in China, there is a reasonable prospect of controlling non-performing loans by securitization.

## V. CONCLUSION

Over the last few decades, the financial sector has become an increasingly important part in all economies, particularly those of the developed world. Increased commercialization has prompted the financial market to innovate. New mechanisms of raising capital have been introduced, and financial products have become increasingly diversified. Securitization as a new form of structured finance has developed rapidly and spread widely into Europe, Latin America and Southeast Asia, with the worldwide securitization market estimated to be in excess of \$4 trillion.<sup>101</sup> Constant innovations make the securitization market increasingly complex.<sup>102</sup> Regulation has developed to counteract this increasing complexity.

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<sup>98</sup> See GAO, *supra* note 16, at 161.

<sup>99</sup> *Id.* at 162.

<sup>100</sup> *Id.* at 164.

<sup>101</sup> See Leixner, *supra* note 46.

<sup>102</sup> See Gangwani, *supra* note 60, at 26.

With the deepening of its economic reforms, China's economy is fast integrating into the world economy. Developing a securitization market has been on China's agenda since the 1990s.<sup>103</sup> The introduction of securitization and the pilot projects are the result of years of careful consideration. Securitization is expected to aid Chinese banks' efforts to improve business efficiency, increase their liquidity and, most importantly, reduce their non-performing loans to a reasonable level.

China has established a supportive legal framework. The law, though requiring further clarification and improvement, is well-designed overall. However, the regulatory work is far from sufficient, and advanced legal infrastructure is needed to accommodate securitization. China needs to enhance the disciplinary power of the market authority, and improve market transparency by codifying disclosure requirements. Furthermore, it needs to accelerate the making and modification of relevant laws including taxation law, bankruptcy law, and trust law to allow investors to benefit from securitization transactions.

China has solid foundations for securitization. More than twenty years' development of the stock exchange has resulted in the existence of a large group of investors and increasingly professionalized intermediary institutions. Moreover, the government is determined to further the implementation of securitization. Hence, securitization is a promising opportunity. It will be interesting to see how securitization unfolds in China in the years to come.

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<sup>103</sup> See HONG, *supra* note 4, at 229.