

# Recent Developments in Assets Securitisation in the PRC

Chinese domestic securitisation, after a few years of rapid growth from 2005 onwards under a variety of pilot schemes, was brought to a halt after the onset of the global financial crisis. Recent measures promulgated in May which promote the re-start of credit asset securitisation are the result of the Chinese authorities' careful consideration of prevalent international market practice. The re-launch of the Chinese domestic securitisation has the stated aims of encouraging a broader range of asset classes and investor participations. We consider the re-launch of the Chinese securitisation market to be an important and inevitable development. We believe the measures are consistent with the internationalisation of the Renminbi, and the continued opening of the domestic capital markets to foreign investments.

We believe there is potential for Chinese securitisation market to be open to foreign investors in the form of either inbound foreign participation or outbound issuance. In this briefing we examine the existing securitisation regimes in China, the recent regulatory and market developments, and issues potential investors may need to consider.

## A Brief Overview of the Chinese Securitisation Market – the Two Regimes

Currently securitisation (or transactions achieving similar economic effect) of assets originated in the PRC are structured under three distinct models: (i) the credit asset securitisation under the *Interim Measures on the Pilot*

## Key issues

- A Brief Overview of the Chinese Securitisation Market – the Two Regimes
- The Credit Asset Securitisation Scheme – Developments since May 2012
- The Corporate Asset Special Management Scheme – Recent Developments
- Other Quasi-securitisation Transactions
- Why is the Re-launch of the Chinese Securitisation Market Important?
- What are the Key Factors Investors Should Consider when Investing in Chinese Securitisation?

*Scheme for Securitisation of Credit Assets* jointly promulgated by the People's Bank of China (**PBOC**) and the China Banking Regulatory Commission (**CBRC**) on 20 April 2005 (**Credit Assets Securitisation Scheme**); (ii) the special asset management scheme under the *Interim Measures on the Administration of Client Assets Management Business by Securities Companies*

promulgated by the China Securities Regulatory Commission (CSRC) on 18 December 2003 (**Corporate Assets Special Management Scheme**); and (iii) other quasi-securitisation transactions carried out without specific regulatory guidelines which were approved on a case-by-case basis. We will not examine the last model in detail in this briefing as we are of the view that this type of arrangement is likely to be bespoke and has less potential to create a functioning market that will attract a broader range of capital markets investors over time.

There are a number of differences between the Credit Assets Securitisation Scheme and the Corporate Assets Special Management Scheme which can be summarised as follows:

- **Regulatory Body.** The Credit Assets Securitisation Scheme is regulated by the PBOC and CBRC while the Corporate Assets Special Management Scheme is regulated by the CSRC. Whilst this appears to be a subtle difference to many investors, it is in fact vitally important as it dictates what regulatory regime is relevant to the originators and what approval process should be followed (which we will elaborate on further below);
- **Eligible Originators.** Eligible originators under the Credit Assets Securitisation Scheme are financial institutions regulated by the CBRC which would typically include banks, trust companies, asset management companies, financing subsidiaries of corporate groups and auto financing companies. There are no specific requirements on the originators under the Corporate Assets Special Management Scheme regime, other than the general requirements that they have sufficient internal control systems, are not exposed to significant financial,
- operational and legal risks and are not in breach of laws or regulations;
- **Eligible Assets.** The assets that are typically securitised under the Credit Assets Securitisation Scheme are assets originated by financial institutions, e.g. residential mortgage loans, corporate loans (including non-performing loans) and auto loans. The Corporate Assets Special Management Scheme traditionally allows a wider scope of assets to be included ranging from leasing receivables to revenues on infrastructure projects; and
- **Investor Base.** Transactions under the Credit Assets Securitisation Scheme are traded in the inter-bank bond market and those under the Corporate Assets

Special Management Scheme are traded on the Shanghai or Shenzhen stock exchanges.

From a legal perspective, however, the key difference between the Credit Assets Securitisation Scheme and the Corporate Assets Special Management Scheme is perhaps the legal regime that governs the transfer and management of assets. The Credit Assets Securitisation Scheme very much relies on the PRC Trust Law and the asset transfer structure typically involves the originator entrusting the assets to a special purpose trust, which, once validly constituted, will be ring-fenced from assets of the originator and segregated from the insolvency estate of the originator and other transaction parties by operation of law. The use of a special purpose trust is not prevalent on the Corporate Assets Special Management Scheme where special asset management plans are set up by securities companies to acquire the assets from the originator. The transfer of assets is therefore very much contract – as opposed to trust - law based. Given the lack of legal certainty on the characterisation of the transfer agreement, it is often difficult for a true sale opinion to be given on this type of transaction. In this respect, although transactions effected under the Corporate Assets Special Management Scheme do have features of a typical securitisation transaction, it is often not considered as a securitisation transaction in its traditional sense.

Both types of asset securitisation in the PRC were active from 2005 to 2008. Since 2005, which is generally regarded as the start of the institutionalisation of the domestic Chinese securitisation market, 11 financial institutions have initiated 17 securitisation projects (until the end of 2008) in the inter-bank bond market through the Credit Assets Securitisation Scheme model, raising a total of Renminbi 66.783 billion. Separately, there have been 11 Corporate Assets Special Management Schemes to date, most of which took place in 2005 and 2006.

New transactions under both models were brought to a halt by the PRC regulators following the global financial crisis as a result of the disruption to the global capital markets and, in particular, changes going through the international securitisation industry. One point worth noting is that the Chinese regulators have never formally repealed any of the regulations or measures in place; they merely stopped approving new transactions to be structured under those regulations until recently.

## The Credit Asset Securitisation Scheme – Developments since May 2012

On May 17 2012, the PBOC, CBRC and the Ministry of Finance (**MOF**) jointly issued the *Notice on the Relevant Issues relating to the Expansion of the Pilot Programs for Securitisation of Credit Assets (May Notice)* to expand the development of the PRC credit asset securitisation market. The May Notice reflects the PRC regulators' careful consideration of the domestic securitisation deals completed to date as well as global regulatory developments since 2007.

We consider the re-launch of the PRC securitisation market by the Chinese authorities to be an inevitable move bearing in mind, for instance, the upcoming Basel III implementation timetable and the requirements already published by the Chinese regulators (for analysis on China's implementation of Basel III, please refer our client briefing named "*China's Implementing Rules on the New Regulatory Standard for the Banking Industry – Stricter than Basel III*" published in September 2011). Compared with the Credit Asset Securitisation regime of 2005, there are several notable developments contained in the May Notice.

### ■ Expanded scope of securitisation assets

The May Notice expanded the scope of securitisation assets and the following are now encouraged: consumer auto loans, infrastructure project loans, agriculture-related loans, loans to small and medium sized enterprises, qualifying loans to financing vehicles of local governments, loans related to energy-saving projects, loans related to strategic emerging industries, loans related to cultural and creativity industry and loans related to affordable housing projects.

The expanded scope of securitisation assets illustrates the current policy initiative, e.g. encouraging the development of small and medium sized enterprises. Broadening the asset classes also reflects the current international market acceptability of certain established sectors, such as auto receivables.

### ■ Additional risk control measures

The May Notice introduced two major measures which aims to bring the scheme closer to current international practice.

First, the originator of the securitisation should retain a portion of the most junior tranche of the securitisation for the entire term of the transaction which shall in principle be no less than 5% of the total deal size. Risk retention has been one of the key regulatory developments in Europe

(through Article 122a under the EU Capital Requirements Directive) and the US (through the ABS retention proposals under the Dodd-Frank Act) since 2007. There are a number of differences between the European and US regime on how risk retention can be achieved which is not the purpose of this briefing. However, compared with the more nuanced regimes in Europe and the US, the Chinese regulators seem to be content with a single ongoing 5% retention through the first loss piece. There is also no mention of whether the 5% retention can be hedged, shorted, sold or otherwise mitigated (although in our view the regulatory intention is not to allow risk mitigating techniques over the retained portion which is designed to align the interest between the originators and the investors).

Secondly, asset backed securities are required to be rated by two credit rating institutions. Previously, one credit rating institution would suffice. The May Notice encourages an investor-pay rating model and encourages investors to establish their internal credit rating system in order to assess the investment risk properly.

### ■ Expanded scope of investors

Under the previous regime, only banks, trust investment companies, financial companies, credit cooperatives and other financial institutions regulated by the CBRC and, since 2008, domestic insurance companies can invest in credit asset securitisation products. The May Notice permitted insurance companies, securities investment funds, enterprise pension funds, national social security fund and other approved non-banking institutions to invest in the securitisation market although it has also limited the holding by an individual financial institution in an individual securitisation to be no more than 40% of the issue size. We will further examine the potential investor base of the Credit Asset Securitisation later on in this client briefing.

### ■ Other notable features of the May Notice

Other notable features of the May Notice include the prohibition of re-securitisations and synthetic securitisations, which is not surprising given the current international regulatory concerns around these products. In addition, the May Notice also provided that the originator shall in principle act as the servicer institution of the securitised assets which is not a requirement in the previous regime. The May Notice also encourages loan level information disclosure (subject to data protection requirements) although has not, at this stage, required loan level disclosure as a mandatory condition.

## The Corporate Asset Special Management Scheme – Recent Developments

The CSRC published the *Trial Guidelines on the Pilot Scheme for Securities Companies Corporate Asset Backed Securities Business* on 30 November 2010 which appears to consolidate and formalize the various CSRC measures and policies in place for Corporate Assets Special Management Schemes although we have not seen these guidelines referred to in the approvals granted to the recent special asset management schemes.

The recent promulgation of the May Notice on credit asset securitisation is considered by many market participants as a signal from the government that the Corporate Assets Special Management Scheme is also in the process of being relaxed. Several market players have announced their plans in launching new schemes. The most recent deal is the special asset management scheme of Nanjing Gongyong Holdings in relation to its right to revenue arising from sewage treatment, approved in December 2011 and listed on the Shenzhen Stock Exchange in March 2012.

In the absence of further clarification on the characterisation of the transfer of assets, legal true sale will remain one of the key issues for this type of transactions. Among the 11 deals completed under the Corporate Asset Special Management Scheme so far, only one of them is perceived to have achieved a legal true sale.

## Other Quasi-securitisation Transactions

Press sources recently reported that, after the issuance of the May Notice, the National Institution of Financial Market Institutional Investors (**NAFMII**) issued the *Guidelines on the Asset Backed Notes of Non-financial Enterprises in Inter-bank Bond Market (Consultation Draft)* (**NAFMII Guidelines**). Unlike the PBOC, CSRC and CBRC, the NAFMII is a self-regulatory body of the investors in the inter-bank bond market. The NAFMII Guidelines, once finalised and published, are unlikely to provide more clarity on the legal or regulatory regime of the domestic securitisation. It is also not clear what approval process transactions structured under the NAFMII Guidelines would be required to go through. From press resources, it seems that the NAFMII Guidelines refer to originator assets being used to provide security for the issue of the notes, rather than an outright sale of the assets. We are of the view that transactions under the NAFMII Guidelines are unlikely to be ring-fenced securitisation transactions and are more likely

to be secured lending transactions with certain asset backed features.

## Why is the Re-launch of the Chinese Securitisation Market Important?

In our view, the re-launch of the Chinese securitisation market is important for a number of reasons, not least in respect of the funding requirements of the near Renminbi 60 trillion outstanding loans held by Chinese banks as well as the capital progression of the Chinese banking industry under Basel III regulations. More generally, it shows the Chinese regulators' stance that, despite the US sub-prime crisis, with adequate and sufficient control and risk management, securitisation can still prove to be an important funding tool for the originators. This corresponds to the continuing albeit gradual return of investor confidence in some market sectors in Europe and the US. Furthermore, the re-launch of the Chinese securitisation market is also compatible with the internationalisation of Renminbi.

Turning to the shape of the market itself, since December 2010, foreign central banks, Hong Kong or Macau Renminbi settlement banks and foreign participating banks of cross-border Renminbi settlement (**Three Types of Institutions**) are permitted to invest in the inter-bank bond market, which would include securitisation products issued under the Credit Assets Securitisation Scheme, subject to the approval by the PBOC.

As to whether qualified foreign institutional investors (**QFIIs**) can invest in credit asset securitisation products in the inter-bank bond market, the position is not entirely clear at present. Although the May Notice did not specify whether foreign investors can invest in domestic securitisation, we understand that the regulators' intention is for investments in Credit Assets Securitisation Scheme products to be limited to domestic investors (at least at the initial stage). However, the CSRC promulgated *Provisions on the Issues Related to Implementing the Administrative Measures for Domestic Securities Investment by Qualified Foreign Institutional Investors* (**New QFII Rules**) on 27 July 2012 which, for the first time, permitted QFIIs to invest in fixed-income products in the inter-bank bond market generally whereas, prior to this, their traditional investments were restricted to the securities traded on the stock exchanges (for a detailed analysis on the New QFII Rule, please refer to our client briefing named "*CSRC New Rules to Buck Up the QFII Program*" published on 31 July 2012).

Although the market generally considers asset backed securities as fixed-income products, it is not entirely clear whether the CSRC had the Credit Assets Securitisation Scheme products in mind when the New QFII Rules were published. We understand that the New QFII Rules may not be presently intended to capture investments in domestic securitisation products although this is not specified in the New QFII Rules. At a practical level, since QFII's investment in the inter-bank bond market is under dual regulation by the PBOC and CSRC, it remains to be seen whether the two regulators can together come up with an appropriate route for QFII's investments in credit asset securitisation products.

As to RMB QFIIs, pursuant to the *Pilot Measures on Investment in Domestic Securities by Fund Management Companies and Securities Companies as Renminbi Qualified Foreign Institutional Investors*, promulgated by the CSRC, PBOC and the State Administration of Foreign Exchange in December 2011 and the *Notice on Relevant Issues in Implementing Pilot Measures on Investment in Domestic Securities by Fund Management Companies and Securities Companies as Renminbi Qualified Foreign Institutional Investors* promulgated by the PBOC in January 2012, RMB QFIIs are permitted to invest in the PRC inter-bank bond market subject to the approval by the PBOC. However, it is again not clear currently whether RMB QFIIs can invest in domestic securitisation products.

Nevertheless, the New QFII Rules illustrate a positive message that the Chinese regulators remain committed to deepening the opening of its domestic capital markets. In our view, should inbound foreign investments be allowed into the domestic securitisation market, it could potentially be the precursor to a further and more definitive move towards outbound issuance by Chinese originators in the international market, in the form of asset backed euro bonds or Renminbi dim sum bonds. However, this process is likely to be tightly controlled by Chinese regulators and anecdotal evidence suggests that this may not happen in the immediate term before a fully functioning domestic market is established.

### What are the Key Factors that Investors Should Consider when Investing in Chinese Securitisation?

Although immediate foreign participation in the domestic securitisation market may not be on the cards, we are of a view that it may only be a matter of time that the domestic market will eventually open up to foreign investors.

Allowing foreign investors into the domestic securitisation market will offer opportunities to investors wishing to diversify existing portfolios and acquire exposures to the Renminbi. At the same time however, it is likely that most investors may feel challenged by the different legal regimes, regulatory frameworks, transaction structures, complexity of the legal issues in connection with the transfer of assets and enforcement of security, to name a few. The following are amongst the key issues that need to be considered by foreign investors when conducting their due diligence:

- credit analysis of the underlying assets, the originator and other service providers;
- transferability of the underlying assets (including security), in particular, issues relating to assignment/transfer of future receivables;
- analysis of any required notification and/or registration requirements under Chinese law by reference to the nature of the assets in the pool including their related security;
- any set-off rights or counterclaims of the underlying borrowers and their impact on the transaction;
- enforcement of the debt and/or security against borrowers under Chinese law;
- insolvency analysis under Chinese law and any claw-back risks;
- valid constitution of the special purpose trust (if using the Credit Asset Securitisation Scheme) and characterisation of the assignment/transfer of the assets (if using the Corporate Asset Special Management Scheme);
- analysis of the security at the special purpose vehicle level for the benefit of investors;
- credit enhancement and liquidity analysis, any currency issues;
- tax issues (withholding tax, business tax, VAT and stamp duty);
- initial and ongoing information reporting; and
- compatibility of domestic versus international credit rating scales

In our view, the eventual foreign participation in the Chinese domestic securitisation market is likely to enhance the due diligence and disclosure standards, as well as pushing legal and risk analysis to a higher level, closer to international standards and best practices. This will be a positive development in the medium term for such foreign investors and China itself.

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