

The development of the ABS market in China and latest market trends

Introduction

Asset-backed securitization (**ABS**) - the process of taking an illiquid asset, or pool of assets, and transforming it (or them) into tradable securities, first emerged in the U.S. in the 1970s and has developed into a mature market in both U.S. and Europe. The ABS market in People's Republic of China (**PRC**), however, is relatively new and still evolving.

History: 2005 - 2009

Securitization was officially established in China after the launch of the credit asset securitization pilot program in 2005, pursuant to a set of administrative regulations promulgated by the China Banking Regulatory Commission (**CBRC**) the main regulator of the banking industry in China and the Chinese central bank, the People's Bank of China (**PBOC**)¹. These regulations comprise primarily of: (i) The Administration of Pilot Projects for Securitization of Credit Assets Procedures (April 2005); and (ii) The Measures for Pilot Supervision and Administration of Securitization of Credit Assets of Financial Institutions (November 2005).

At the same time, the China Securities Regulatory Commission (**CSRC**), the main regulator of the securities industry in China, also launched its first securitization scheme pursuant to administrative regulations entitled Interim Measures on Managing Client Assets by Securities Firms (August 2005). Under the CSRC's 2005 regulations (which were seen at the time to rival the CBRC regulations), securities companies could apply to the CSRC for approval to establish a "selective asset management plan" (**SAMP**). However, neither program continued indefinitely. The CSRC SAMP program was soon discontinued as the structure relied heavily on third party guarantees due to perceived difficulties with legal isolation. The onset of the 2007 global financial crisis led to the suspension of the securitization program supervised by the CBRC in 2009.

The current view of securitization in China

In 2012, securitization re-emerged in China after the PBOC, CBRC and the Ministry of Finance jointly issued a notice to expand the credit asset securitization pilot program. Since then, the securitization market in China has grown very rapidly. Securitization is viewed by the PRC government as an alternative funding source and balance-sheet-management tool to help alleviate China's shadow banking problems.

We'll talk about the different structures below and then talk about what is happening in the market at the moment.

The securitization regimes in China

There are two regulatory regimes in China for securitization: the Credit Asset Securitization (**CAS**) and Asset-Backed Specific Plan (**ABSP**) Schemes, and we discuss each of these below. There is currently no consolidated securitization statute or law in China, although there are general PRC laws which are applicable to securitizations, including PRC Contract Law, PRC Property Law, PRC Enterprise Bankruptcy Law and the Measures on the Administration of Bond Transactions in the Inter-bank Bond Market.

What is China's shadow banking problem?

Since the 2007 global financial crisis, China has invested huge amounts into its economy. As well as formal bank loans, money has also been funneled into the economy through a variety of other channels, including shadow banks. Chinese officials are keen to bring this under control and are focusing on channeling assets towards the real economy. To this end, alternative funding sources and balance-sheet-management tools such as securitization are appealing.

¹ For the purpose of this article, PRC does not include the Hong Kong Special Administrative Region, the Macau Special Administrative Region or Taiwan.

CAS Scheme

The CAS Scheme (sometimes known as **CASS**) is specifically for financial institutions and uses the special purpose trust (**SPT**) structure under the PRC Trust Law.

Key features to note are:

- The CAS scheme is regulated by the CBRC and the PBOC.
- Under the CAS Scheme, banks and non-bank financial institutions licensed by CBRC may entrust loan receivables comprising “credit assets” to a CBRC-licensed trust and investment company as trustee.
- Under a SPT, the receivables typically securitized are credit assets of the originator, including consumer auto loans, infrastructure project loans, agriculture-related loans, qualifying loans to financial vehicles of local governments, loans related to strategic emerging industries, residential mortgage loans and loans related to affordable housing projects.
- In practice, the asset classes most frequently securitized under SPTs are residential mortgage loans, corporate loans (including non-performing loans) and auto loans.

ABSP Scheme

The ABSP Scheme is used by all non-financial institution issuers and therefore dominated by corporate issuance where such securities are listed either on the Shanghai or Shengzhen Exchange or private issuances over-the-counter.

Key features to note are:

- The ABSP Scheme is regulated by the CSRC.
- The ABSP Scheme uses the SAMP structure, which is set up by a securities company as an asset management scheme (not a trust) to acquire the underlying assets from the originator (usually a cooperation).
- The legal basis for the SAMP stems from the CSRC Securitization Measures.

- The ABSP market consists of a broad range of assets, including securitized assets issued by state-owned enterprises (SOE), corporate receivables, creditors’ rights under leases, credit assets, beneficial interest in trusts, profits from infrastructure projects and commercial real estate and other assets or property rights.
- According to one source², SOE restructuring is high on the agenda of many local governments and as part of the restructuring, local governments are supporting the securitization of SOE assets. For example, the East China’s Shandong province recently released guidelines to support securitization of SOE assets and by 2020, it plans to bring at least three SOEs or their core businesses onto the capital market and raise the securitization rate of provincial-level SOEs to more than 60 percent.

Asset-backed notes

Another form of securitized product in China is the asset-backed note (**ABN**). This structure is similar to a loan secured by assets of the issuer (being a non-financial institution), or a “covered bond” structure. However, there is an important distinction: there is no supporting legislation allowing for the segregation of the assets backing the note from the issuer’s other assets. Therefore, an ABN issue is sometimes referred to as a “quasi-securitization”.

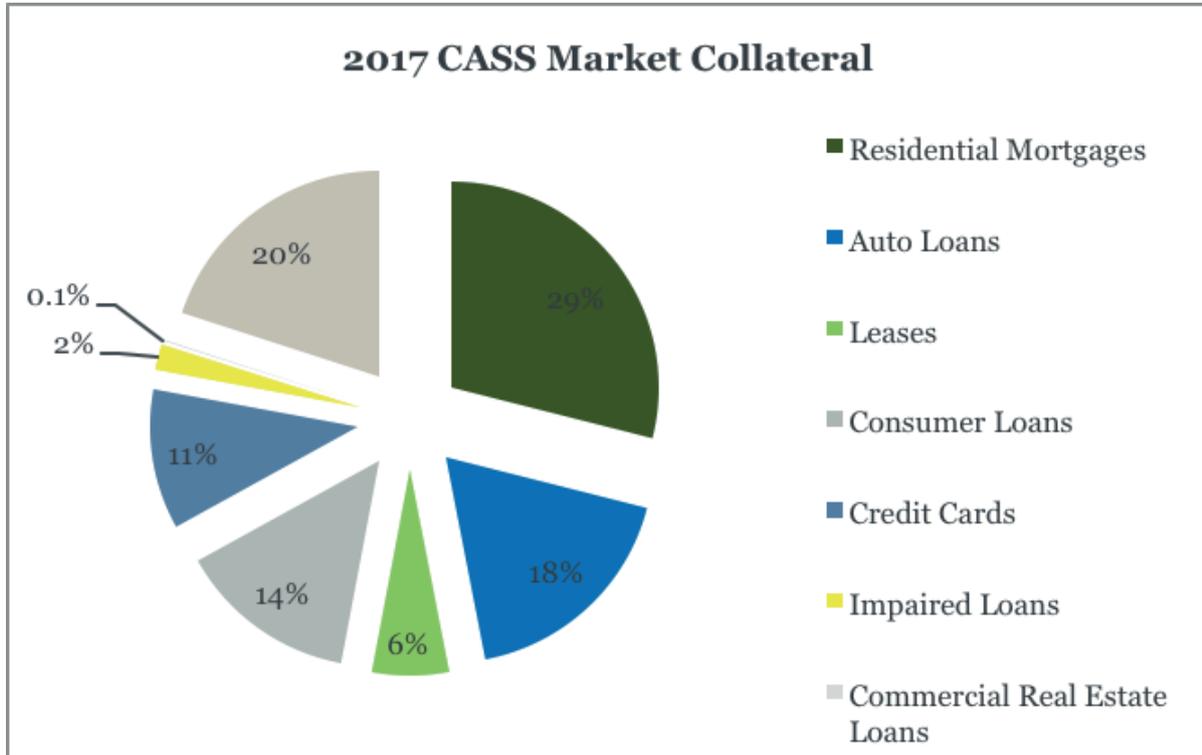
Developments in the securitization market in China

Since its revival, the securitization market in China was initially slow during 2012-2013 but picked up steam in the second half of 2014 and has been on a rapid growth trajectory ever since. In 2017, the total volume of issuance of asset-backed securities (**ABS**) in China reached US\$230bn, marking a 65.86% increase compared to 2016. The total outstanding volume of ABS by the end of 2017 stood at US\$326bn, a 66.41% increase from 2016.³

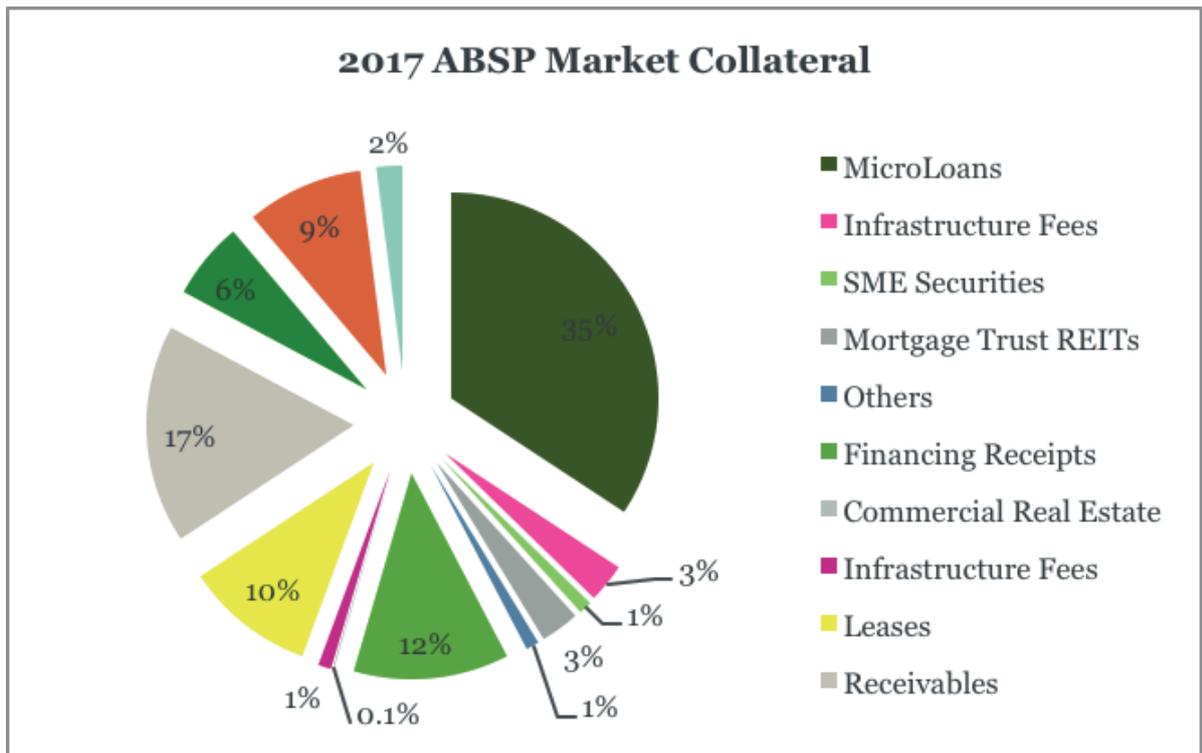
² China Daily – “China SOE reform set to accelerate”, 26th October 2017

³ Figures in this paragraph are taken from the 2017 Asset-Backed Securities Development Report, published by the China Central Depository & Clearing Co., Ltd., pg.6 (2017年资产证券化发展报告)

As can be seen from the charts below, a wide range of assets have been used in securitization deals in each of the CASS and ABSP markets.



CASS Market Collateral, 2005-2015 (Wind, January 2018)



ABSP Market Collateral, 2005-2015 (Wind, January 2018)

Property ABS market in China

One area where there is reportedly a lot of growth in China at present is the property ABS market. This market includes residential mortgage-backed securities (**RMBS**) and commercial mortgage-backed securities (**CMBS**) issued under the CAS Scheme or the ABSP Scheme. Property ABS are becoming more popular as an alternative funding solution in light of the lower funding costs compared to loans due to the Chinese government tightening their policy and imposing high thresholds and costs for securing bank loans and issuing corporate bonds.

Property ABS can also help banks to transfer some of their liquidity risks to investors and free up cash flows of long-term loans for other investments.

As insurance companies are expressly allowed to invest in property and ABS products pursuant to the Measures for the Administration of the Utilization of Insurance Funds (which came into force on 1 April 2018), we anticipate that Chinese insurance companies will increasingly invest in property ABS products. The lower interest rates in the domestic loan market and a need for portfolio diversification will make this product attractive.

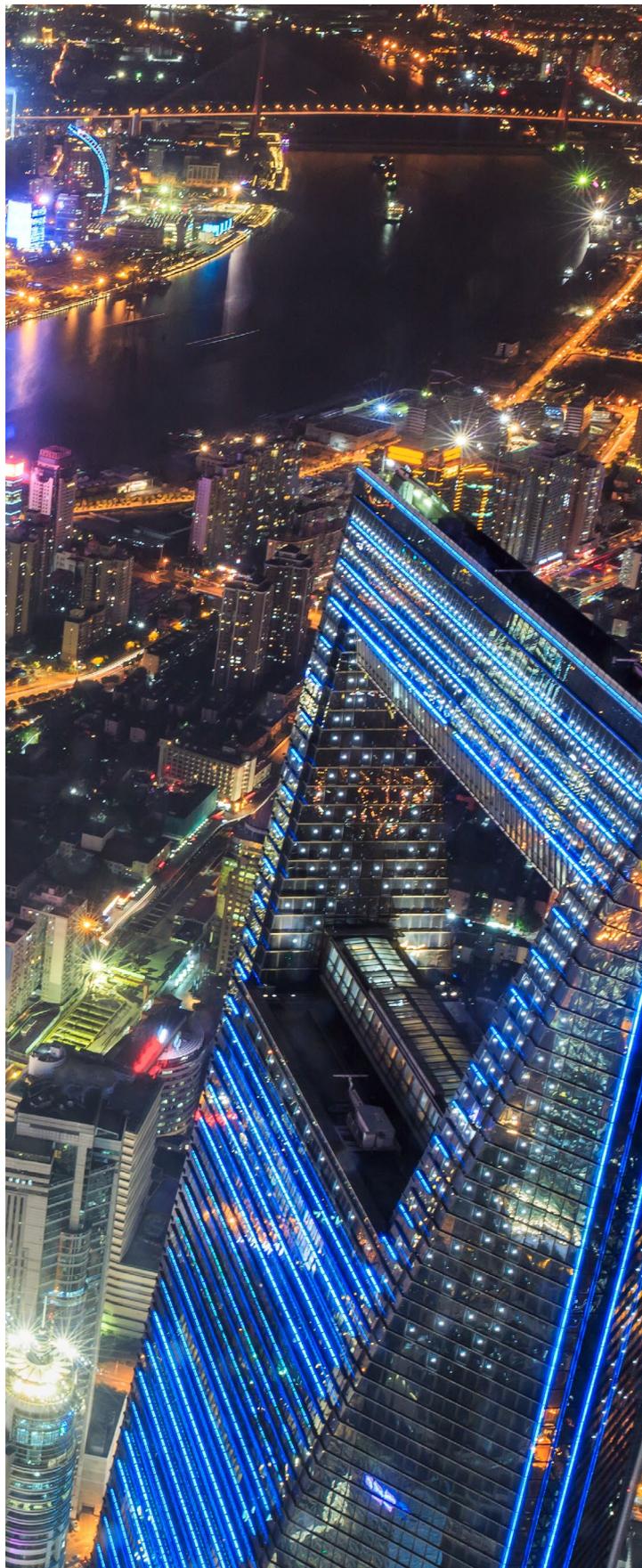
How the China property ABS market compares to ABS in developed markets

The property ABS market in China has developed rapidly in recent years. However, it is still at a nascent stage compared to developed markets and there are several reasons for this.

First, given the complexity of the property ABS products and lack of retail participants, there is no secondary market for property ABS in China.

Secondly, stringent financial regulation means there is a lack of origination of securitized assets.

Finally, the issuance of RMBS is limited due to incomplete individual credit data.



Legal issues

Whilst the ABS market continues to grow in China, there remain a number of legal issues which need to be addressed. We highlight some of these below:

- One fundamental issue is that the CAS and ABSP Schemes are fairly new, and as such are untested (or inadequately tested) in PRC courts. Even if an insolvency of a key securitization party or participant (e.g. the sponsor or the manager) were to occur that was adjudicated by a PRC court in favor of the integrity of the securitization scheme, there is no precedent in the PRC.
- Furthermore, both the CBRC and CSRC regulations are not statutory law. Being a civil law jurisdiction, it is important that the securitization schemes in the PRC are codified in statute, in order to create clarity and certainty for market participants.
- Another issue is that under the Security Law and Property Rights Law, mortgages over “immovable” (e.g. real estate) require registration to create the mortgage whereas mortgages over “movables” (e.g. motor vehicles) are created by contract and require registration only to perfect the mortgage. This could pose a challenge, especially for RMBS where there would be a large number of re-registrations involved. The Ministry of Housing and Urban-Rural Development issued a notice (as a trial) to facilitate the efficient registration of any change to the underlying residential mortgage loans of RMBS by allowing the originator to file with the registrar any mortgage associated with residential mortgage loans in bulk and to notify all the debtors in bulk by way of disclosure of the mortgage transfer using specified media. ABS transactions involving mortgage-secured auto loans, on the other hand, may be more feasible in terms of transferring rights in collateral.
- Under the Security Law and Property Rights Law, it is not technically possible to create a security interest over a bank account. The “lock-box” account concept is not available in the PRC as a way for buy-side parties to control cash so other arrangements must be made, such as diversions of funds paid by obligors on day one.



Future outlook

The ABS market in China has been highly successful to date. The legal and regulatory challenges remain (and we have only highlighted a few examples of these).

According to a report by Pengyuan International, a credit rating agency, demand remains strong: the issuance of transactions backed by commercial real estate assets will continue to increase, driven by favorable policies in the housing rental market and property developers' incentives to diversify their financing channels.

Certainly its importance as an alternative funding source and balance-sheet-management tool is something that should not be forgotten and it is an important arrow in the Chinese government's quiver.

The recent trend of tightening regulations and increasing enforcement actions (such as the new regulations on capital, liquidity and risk management for banks issued by the CBRC) may continue and we expect that China's ABS market will continue to grow in 2018 and into 2019, albeit at a more moderate pace than in the last couple of years.

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