

The rising and booming Chinese securitization market – a comparison with the European securitization market

Since 2005 the Chinese securitization market has been developing into one of the most vigorous securitization markets. China is now the second biggest securitization market in the world. Over the last fourteen years the Chinese securitization market has learned lessons and experiences from other developed markets, such as the US and EU market models. However, as an emerging market, the Chinese securitization market has developed particular features and has deviated significantly from the US and EU market models. Below we will mainly compare the Chinese securitization market and the European securitization market.

Segregated securitizations market

Following the implementation of the new EU Securitization Regulation (Regulation (EU) 2017/2402) (the **EU Securitization Regulation**) on January 1, 2019, there are now two kinds of securitizations in the EU, the so-called simple, transparent and standardized securitizations (**STS**) and other securitizations which do not fulfil the STS criteria.

The STS criteria include:

- **Simplicity requirements:** the originator/sponsor/original lender must ensure simplicity of the transaction structure and homogeneity of the securitized assets. “Homogeneous” for these purposes means being in the same asset type where the contractual, credit risk, prepayment and cash-flow related characteristics are sufficiently similar;
- **Transparency requirements:** the originator/sponsor/original lender must ensure the availability of sufficient information on the securitized assets, transaction structure and parties involved in the transaction. These go beyond the general disclosure obligations and include disclosure of static and dynamic historical default and loss performance data, an external verification of a sample of the underlying exposures and a liability cash flow model;
- **Standardization requirements:** the originator/sponsor/original lender must ensure that investors are able to understand and compare securitization transactions without relying on third party assessments. The standardization criteria include, among other matters, requirements for key provisions in documentation and servicer expertise.

The main benefit of a securitization complying with the “STS” criteria concerns only preferential regulatory capital treatment like the liquidity coverage ratio (**LCR**).

In comparison, China has four segregated securitization markets which comprise of different originators, provide different platforms for the issuance and trading of securitization products and are subject to separate regulatory regimes and different administrative authorities:

- Credit asset-backed securitization (**credit ABS**) issued by banks and non-banking financial institutions through special purpose trusts on the China Interbank Bond Market (**CIBM**), including assets such as residential/commercial mortgage, auto loans, corporate SME loans, credit card receivables and customer loans;
- Corporate assets-backed securitization (**corporate ABS**) issued by enterprises through special asset management plans (**SAMP**) mainly on stock exchanges, including assets such as consumer loans, trade receivables, factoring receivables, leasing receivables, trust beneficiaries, fee income and REITs;
- Asset-backed medium-term notes (**ABN**) issued by non-financial enterprises through special purpose trusts or special purpose companies on CIBM, including assets such as leasing receivables, trade receivables, factoring receivables, notes receivables, commercial mortgage and fee income; and
- Asset backed plans (**ABPs**) issued by insurance asset management companies on insurance exchanges (e.g. the Shanghai Insurance Exchange) (this market has a very small market share).





Form of the securitization special purpose vehicle

A securitization special purpose vehicle is an entity established for the purpose of carrying out securitizations. Its activities are limited to those appropriate to accomplishing that objective. This kind of transactional structure is intended to isolate the assets of the issuing entity from those of the originator. In Europe, the special purpose vehicle is usually in the form of a corporation like a section 110 company (an Irish tax resident company, which qualifies under Section 110 of the Irish Taxes Consolidation Act 1997 to help the International Financial Services Centre legal and accounting firms compete for the administration of global securitization deals, and by 2017 was the largest structured finance vehicle in EU securitization). As an independent entity, such special purpose vehicle can easily satisfy bankruptcy remoteness from the originator.

In China, the majority of securitization transactions use the form of a trust (for credit ABS and ABN) and the so-called special assets management plan (**SAMP**, for corporate ABS) as the special purpose vehicle. The form of passive company used in European securitization transactions is not permitted under the Chinese Company law pursuant to which a company that fails to commence business within six months after its establishment or which ceases to engage in business for a period of six months or more after commencing business should be liquidated. Under the Chinese Trust Law, trust and investment companies may hold credit assets in trusts and issue ABS notes as issuers. The assets entrusted to the trusts are separated from the assets of originators and the issuers in case of the bankruptcy of the relevant originator and issuer.

The SAMP structure for corporate ABS is actually only a contractual arrangement, which lacks legal clarification of its nature. Theoretically, the receivables which are transferred to the managers (usually securities firms or subsidiaries of fund management companies) are independent from all parties (originators, managers and custodians etc.) and should not be included in the bankruptcy property of the originator, the manager and/or the custodian in case any of such parties is liquidated due to dissolution, or declared insolvent in accordance with the Chinese laws.

Segregated legal and regulatory regimes

The EU Securitization Regulation has introduced a unified legal framework across the EU including requirements on due diligence, transparency, repositories, risk retention, credit-granting, sanctions and regulatory capital treatment.

There is just one EU supervisory authority with regulatory authority, namely the European Securities and Markets Authority (**ESMA**).

By contrast, the segregated Chinese securitization markets are regulated by different supervising authorities:

- Credit ABS: People’s Bank of China (**PBOC**) and China Banking and Insurance Regulatory Commission (**CBIRC**, formerly known as China Banking and Regulatory Commission or **CBRC**);
- Corporate ABS: China Securities Regulatory Commission (**CSRC**);
- ABN: National Association of Financial Market Institutional Investors (**NAFMII**), a self-regulatory organisation under the PBOC;
- ABPs: China Banking and Insurance Regulatory Commission (**CBIRC**)

In addition, the Chinese government has not yet adopted any unified legislation regarding securitizations. There are only measures, circulars and guidelines concerning different issues published by the relevant administrative authorities. This could be because the market is still in its infancy. The Chinese government needs to collate more experience from the market.

One significant change of note is that the regulatory requirements are now in the form of registration and filing: there is no approval process any more.

- Credit ABS: issuance filed with the CBIRC and registered with the PBOC;
- Corporate ABS: the SAMP scheme filed with the Asset Management Association of China (**AMAC**) and the local office of the CSRC;
- ABN: issuance registered with NAFMII;
- ABPs: the initial ABP shall be approved by the CBIRC in advance. The subsequent similar plans can be reported to the CBIRC after issuance.

Due diligence

The EU Securitization Regulation sets out harmonized due diligence requirements that apply to “institutional investors”, including credit institutions, investment firms, insurers, re-insurers and alternative investment fund managers, as well as Undertakings for Collective Investments in Transferable Securities (**UCITS**) and pension funds. An institutional investor must establish written procedures in order to monitor the performance of a securitization position and its underlying exposures and be able to demonstrate to its competent authorities, upon request, that it has a comprehensive and accurate understanding of the securitization position and of the underlying exposures.

In contrast, Chinese regulators impose due diligence requirements on the managers of the issuance (securities firms in case of SAMP or trust companies in case of Credit ABS and ABNs) concerning the basic assets and all the participants of the transaction, especially the originator. Therefore, the repayment ability of the originator has greater importance in China.

Recently (in April 2019), the CSRC issued more specific requirements regarding the types of basic assets, the qualification and ability for continually managing the basic assets of the originators. Future film box office earnings, property management fees and commercial rent with no mortgage cannot constitute basic assets. The issuance managers need to cautiously calculate the costs and taxes for continually managing the basic assets during the lifetime of the SAMPs.

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Structuring and Transaction process/timeline

Structuring is always a core issue in the European market. The EU Securitization Regulation explicitly prohibits re-securitizations following the global financial crisis a decade ago. The Chinese securitization market actually took off after the global financial crisis in 2008. Re-securitization and synthetic securitizations that were regarded as the causes behind the financial crisis have been forbidden in China. The common structure is the simple pass-through structure. For a long time securitization transactions in China had been subject to a lengthy approval process by the relevant regulators. Since 2014, the Chinese regulators have switched from approvals to a registration/filing process, significantly relaxed the administrative process and shortened the issuance timeline.

In Europe, most time is spent structuring the securitization and locating investors, whereas in China more time is spent on the administrative procedures and structuring, selling usually starts at the very beginning of the transaction (presale-model).

Risk retention

In accordance with the risk retention obligation (skin in the game) under the EU Securitization Regulation, originators, sponsors and original lenders are required to retain a material net economic interest of not less than 5%, either horizontal or vertical retention or random selection. The retention methods include:

- the retention of not less than 5% of the nominal value of each of the tranches sold or transferred to investors;
- in the case of revolving securitizations or securitizations of revolving exposures, the retention of the originator's interest of not less than 5% of the nominal value of each of the securitized exposures;
- the retention of randomly selected exposures, equivalent to not less than 5% of the nominal value of the securitized exposures, where such non-securitized exposures would otherwise have been securitized in the transaction, provided that the number of potentially securitized exposures is not less than 100 at origination;
- the retention of the first loss tranche and, where such retention does not amount to 5% of the nominal value of the securitized exposures, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total not less than 5% of the nominal value of the securitized exposures; or
- the retention of a first loss exposure of not less than 5% of every securitized exposure in the securitization.

In China, there are only general requirements for the 5% risk retention on the originator and this is often measured by the total issued securitization notes. In practice, the originator often holds the subordinated tranche and, as a result, it is very difficult for Chinese originators to have an off-balance sheet transaction:

- an originator shall hold at least 5% of each securitization product issued by it;
- the proportion of asset-backed securities (ABS) in the lowest tranche held by an originator shall be no less than 5% of the issued ABS in such tranche;
- where an originator holds ABS of tranches other than the lowest tranche, the originator shall hold ABS in all such tranches at the same proportion; and
- the term of the above holdings shall be no less than the validity term of the ABS in the relevant tranche.

Disclosure

Under the transparency requirements of the EU Securitization Regulation, the originator, the sponsor and the special purpose entity must designate amongst themselves one entity (the **Reporting Entity**) to fulfil the reporting requirements, which must be expressly indicated in the relevant transaction documents. The Reporting Entity must (except for private deals) make the relevant information available by means of securitization repository or a website.

- Before pricing, the Reporting Entity must make available:
 - the documentation that is essential for the understanding of the transaction: i.e. the transaction documents.
 - in case of STS securitization, the STS notification;
 - in case of a securitization where a prospectus has not been prepared, a transaction summary or overview of the main features of the securitization, including: diagrams containing an overview of the transaction; the ownership structure; the cash flows; details regarding the exposure characteristics; the priority of payments, and details regarding the voting rights of the noteholders and their relationship with other secured creditors.
- During the securitization's lifetime, the Reporting Entity must periodically (at least quarterly) make available:
 - information on securitization positions; and
 - an investor report including: performance of the underlying exposures; data on trigger events entailing any changes in the priority of payments or substitution of any party of the transaction; data on the cash flows generated by underlying exposures and by the liabilities of the securitization; and data on the risk retention (e.g. which retention modality has been applied thereto).

In China, in light of the segregated regulatory regimes, there are also different disclosure regulations, guidelines and/or rules regarding to different securitizations. Moreover, for credit ABS, there are also respective guidelines for each kind of basic assets.

Unlike the EU Securitization Regulation, all participants of the issuance in China generally need to fulfil disclosure requirements before pricing and during the lifetime of the securitization (at least yearly). For credit ABS, the disclosure obligation needs to be fulfilled at the registration stage.

In addition to the general information, the disclosure for credit ABS focusses more on the data of loan history and the cash flow statistics, whereas that for corporate ABS focusses more on the situation of the basic assets, the selection criteria and structure of the continuous purchasing and other relevant factors. There are also unfolding and increasing disclosure requirements on large assets, floating interest rate, early termination of lease and historical performance data in relation to leasing ABNs.



Final thoughts

With China-US trade tensions continuing and even escalating, China has pledged to further open its massive financial markets to foreign investors. Chinese Premier Li said in March 2019 that “the government also will work on more favorable policies for foreign investors to trade Chinese bonds.” As a result, there will no doubt be more European investors investing in Chinese bonds, including securitization bonds. Understanding the differences between the Chinese securitization market and European securitizations will assist European investors that are investing or considering an investment in Chinese asset backed notes or securities.

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