

THE SECURITISATION & STRUCTURED FINANCE HANDBOOK
2018

APSA
Asia-Pacific Structured Finance Association

PRC securitisation: Legal and rating developments

by Kingsley Ong[1] & Stan Ho,[2] Asia Pacific Structured Finance Association (APSA)

The 1997 Asian financial crisis demonstrated how excessive concentration of credit and liquidity in the banking sector made economies vulnerable to systemic economic collapse. The Asian financial crisis saw many Asian currencies attacked and suffer significant de-valuation. The People's Republic of China (China or PRC) was relatively insulated from that 1997 Asian financial crisis because of one key reason – its strict exchange controls of the local CNY currency. On the other hand, the 2008 global financial crisis demonstrated the risks of China's over-reliance on the US dollar as its reserve currency, and the limitations of CNY remaining a controlled currency.

Introduction[3]

In recent years, China has implemented a long-term policy of internationalising the CNY. Expansion of the offshore CNY markets started initially in Hong Kong and then extended to other major global and regional financial centres. Over the past five years, the People's Bank of China (PBOC) has signed bilateral local currency swap agreements with more than twenty central banks, including the European Central Bank, to provide backstops for CNY liquidity in case needed.[4] Today, we see CNY products (such as offshore CNY bonds, aka dim sum bonds) traded freely among non-Chinese residents. Once offshore, CNY is now fully convertible. As a further liberalisation, in mid-2014, China's State Administration of Foreign Exchange (SAFE) issued the "Provisions on the Administration of Foreign Exchange for Cross-Border Security", and the "Administration of Foreign Exchange for Cross-Border Security Implementation Guidelines". These new SAFE rules relaxed restrictions for granting of guarantees and onshore security for offshore financing. Notwithstanding these developments, cross-border CNY flows are still managed.




Kingsley Ong Stan Ho

Kingsley Ong, Secretary-General & Director

Stan Ho, Director

tel: +852 2186 3239

+852 2616 8196

email: kingsley@apsa-asia.com

stan@apsa-asia.com

In order to move to the next stage of internationalising the CNY, lessons from the 1997 Asian financial crisis show the importance of having strong and diversified capital markets to ensure long-term economic and currency stability.

In line with this goal, China has been rapidly developing its asset securitisation industry, which is an integral and fundamental part of developing and diversifying its debt capital markets industry. To date, China's securitisation market is already the largest in Asia[5] and second largest in the world.[6]

China securitisation legal framework

Asset securitisations in China were traditionally structured under two key models: the pilot securitisation framework (PSF) and the asset backed specific plan (ABSP).

In 2012, a new type of asset-backed securitisation notes regulated by the National Association of Financial Market Institutional Investors (NAFMII) was issued.

PSF (for financial institutions only)

The PSF (sometimes also referred to as the credit asset securitisation framework) was launched in April 2005, and is regulated by the PBOC and China Banking Regulatory Commission (CBRC).[7]

A key element for the success of a securitisation is the legal isolation (typically achieved through a legal "true sale")[8] of the underlying assets from the originator into a bankruptcy remote vehicle. The PSF model achieves this by way of entrustment under the PRC Trust Law.[9] Eligible trustees are confined to trust companies with the relevant trust license issued by CBRC. In addition, trust plans[10] are regulated by CBRC.

Article 15 of the PRC Trust Law provides: "*The trust shall be differentiated from other property that is not put under trust by the settler. Where, after a trust is created, the settler dies or is dissolved or cancelled according to law, or is declared bankrupt, and the settler is the sole beneficiary, the trust shall be terminated, and the trust property shall be his legacy liquidation property; where the settler is not the sole beneficiary, the trust shall subsist, and the trust property shall not be his legacy or liquidation property; but if the settler is one of the co-beneficiaries and dies or is dissolved, or cancelled according to law, or is declared bankrupt, his right to benefit from the trust shall be deemed his legacy or liquidation property.*"

Article 16 of the PRC Trust Law provides: "*The trust property shall be segregated from the property owned by the trustee (hereinafter referred to as his "own property", in short), and may not be included in, or made part of his own property of the trustee. Where the trustee dies or the trustee as a body corporate is dissolved, removed or is declared bankrupt according to the law, and the trusteeship is thus terminated, the trust property shall not be deemed his legacy or liquidation property.*"

The combination of Articles 15 and 16 confirm that entrusted assets will not form part of the bankruptcy estate of the defaulted settler or trustee. This protects the concept of "legal isolation" of assets and "bankruptcy remoteness" of the trustee vehicle, both required for a successful securitisation.

So far, the PSF model has been the most successful model. For example, in 2006, strong international ratings from major credit rating agencies were achieved for a cross-border commercial mortgage backed securitisation (CMBS) transaction.[11] In August 2014, two leading international credit rating agencies assigned strong international ratings to a domestic auto loan securitisation transaction in PRC for the first time.[12]

A large part of the success of the PSF model lies with the robust legal framework available through the PRC Trust Law, which is a State Law. Through an entrustment under the PRC Trust Law, legal true sale and legal isolation of the underlying assets is achieved.

However, the PSF model is exclusively for CBRC-regulated financial institutions only (e.g. commercial banks, finance companies, etc.). Non-financial institutions are not eligible to use this model.

ABSP (for non-financial institutions)

Non-financial institutions seeking to issue asset-backed financial instruments had to use the model previously known as the "SAMP" (Specific Asset Management Plan,[13] which was launched in December 2003. The SAMP model was recently renamed the "ABSP" (Asset Backed Specific Plan) model. This is regulated by the CSRC.

Unlike the PSF model which uses a special purpose trust, under the ABSP model, ABSPs set up by securities companies will acquire assets from the originator. The transfer of assets is based on contract, rather than entrustment.

A difficulty of the ABSP model is the lack of certainty on the characterisation of the transfer agreement, creating uncertainty for legal true sale. Indeed, major international rating agencies have expressed reservations: "*In the event that the project manager goes bankrupt, creditors of the bankrupted project manager may have a pari passu claim as the ABSP investors over the ABSP assets.*"[14]

CSRC has tried to clarify the legal position.[15] Notwithstanding this, due to public law concerns about the legal status of the ABSP model, the ABSP model has been less successful than the PSF model.[16] As at August 2016, it was noted that issuance volumes for securitisation notes by Chinese corporates have been low, with "only 82 deals worth a combined CNY26.29bn issued since 2012". The low issuance was attributed to a "lack of bankruptcy remoteness protection offered by the traditional ABN structure, which more resembles senior secured debt than securitisation paper".[17]

NAFMII (for non-financial institutions)

According to the Guidelines on Asset-backed Notes for Non-financial Enterprises on the Interbank Bond Market issued on August 3, 2012 ("NAFMII ABS Guidelines"), NAFMII has the mandate to regulate asset-backed notes originated by non-financial institutions which can be traded on the interbank market.

This new type of asset-backed notes uses the trust structure (like the PSF model), but can be used for non-financial institutions. Previously, Chinese corporates issued securitisations under the ABSP, as corporates cannot issue under PSF because they are not regulated by PBOC and CBRC. Since the NAFMII ABS Guidelines were introduced, multiple ABS transactions have been done under this framework.[18]

While the introduction of NAFMII ABS Guidelines is positively welcomed, there have been doubts on its viability. The concerns are generally related to the public law status of NAFMII ABS Guidelines.[19] NAFMII is a self-regulated body of investors in the inter-bank bond market (unlike regulators like PBOC, CBRC or CSRC).

It was observed 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",[20] and "[t]ransactions registered so far are akin to secured lending transactions with certain asset backed features. This product is unlikely, in its current form, attract foreign investors due to the lack of ring-fencing and tranching of risks".[21]

Nonetheless, Moody's noted that "as trust structure ABN become more widely accepted by investors in the interbank bond market, it will … expand the scope for corporates to raise funds through this channel".[22] The NAFMII model is still evolving, and it remains to be seen whether this will become a dominant securitisation model in China.

Onshore PRC securitisation rated AAA (international rating scale)

The credit rating of securitisations can be capped by rating agencies for different reasons. For instance, the market and originator portfolio data may only cover a short time period without going through any stress cycle. The data provided may not be in good detail for rating agencies to fully understand and analyse for their credit rating. The portfolio may have concentration to a particular region or obligor. In Asia, the major reason for rating cap imposed on securitisation transactions is the sovereign credit rating.

Currently, Fitch, Moody's and S&P assign China long-term sovereign ratings at A+ (stable outlook), A1 (stable

outlook) and AA- (negative outlook) respectively. For Moody's, China's local currency country ceiling of Aa3, capturing the systemic risks associated with the political, institutional, legal and economic factors prevalent in China, caps Moody's rating on China securitisation at Aa3(sf). For Fitch, the early stage of the securitisation market development as well as China's country ceiling of A+ caps Fitch's rating on China securitisation at AA(sf). Moody's and Fitch are adopting similar securitisation rating cap approach due to the sovereign risk in the other markets as well.

In April 2017, S&P assigned a AAA(sf) rating to the CNY2.5bn class A notes issued by Fuyuan 2017-1 Retail Auto Mortgage Loan Securitization Trust. The transaction is backed by a static pool of auto loan receivables originated by Ford Automotive Finance (China), a wholly owned subsidiary of Ford Motor Credit Company. This is the first time a China securitisation is rated AAA on an international rating scale. The same transaction was rated by Fitch at AA(sf).

S&P explained in the pre-sale report why this transaction can be rated AAA(sf). First, the credit enhancement and the liquidity reserve fully funded at closing provides adequate support for the notes to pass S&P rating stress cash flow scenarios correlated with a "AAA" rating level. The class A notes benefit from the fully sequential and turbo principal repayment mechanism, and excess spread can be used to further pay down the class A note principal. The report also mentions S&P's comfort with the originator's established track record and stable underlying policies, as well as the limited exposure period (25-month weighted average remaining loan term) of the underlying collateral pool.

Split credit rating is quite common for corporate and securitisation ratings. As long as such split rating exists, the transaction pricing as well as the investor credit analysis and investment consideration for such transactions will still be affected by the lower assigned rating. We expect that China's securitisation market will continue to expand in terms of new issuance volume, outstanding amount and diversity of asset classes.

However, China's securitisation market history is still relatively short and the robustness of its legal framework may not be comparable to other more developed securitisation markets. Hence, we believe that the AAA(sf) impact of S&P rating on China securitisation is likely to be limited unless one of either Moody's or Fitch also can rate China securitisation at Aaa(sf)/AAA(sf) with very supportive and convincing rationale for investors.

Local government bond repackaging (offshore) completed by BOC Shanghai

Bond issuance by local government financing vehicles (LGFV) was boosted by the economic stimulus program that was initiated by the central government in 2008. LGFV bonds have a broad range of maturities, with six to seven years the most common, and higher financing cost than local government bonds. Not all LGFV bonds are rated.

To support the development of local government bond markets, a collateralised debt obligation (CDO) structure can be employed to assist weaker local governments to access the bond market. CDOs are bonds issued and backed by the predicted cash flows from specific loans. CDO can involve setting up a special purpose vehicle which buys loans from different originators and sells the notes, backed by the portfolio of the bought loans, to the investors. This is called a cash CDO, and investors can enjoy the diversification benefit of a larger number of loans in the transaction, rather than single credit exposure to any underlying loan.

For China's local government and LGFV debt, the CDO structure could be packaged in different ways. For instance, the local government can pool various LGFV debts and package them into a CDO to be sold to investors. Alternatively, the central government can pool various local government debts and package them into the CDO. Even a portfolio comprising both LGFV and local government debts can be pooled to back a CDO. The bottom line is that the correlation among each underlying debt should be limited in order to have diversification benefit, which should lead

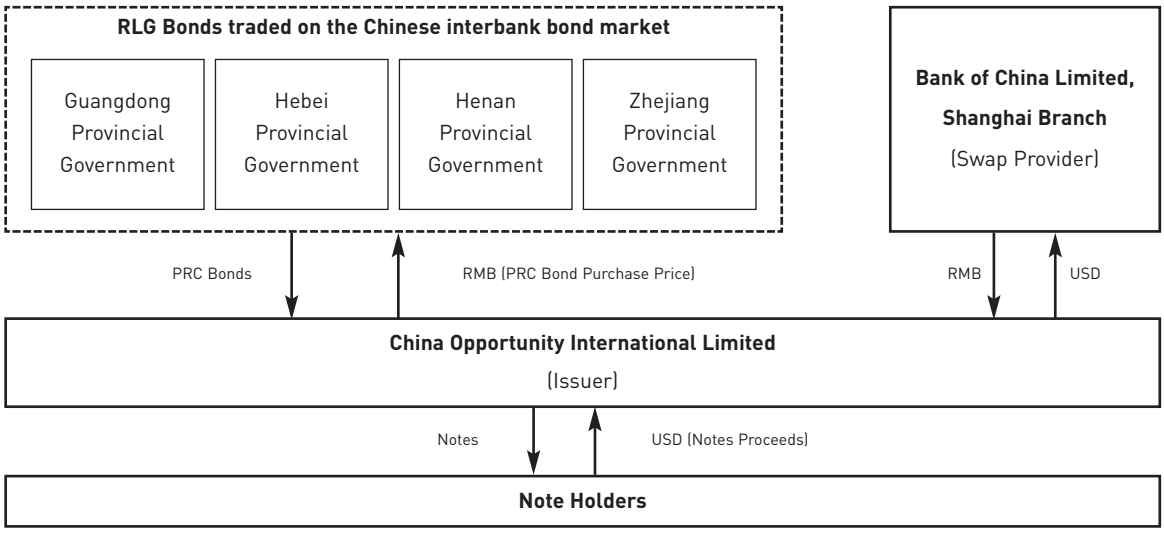
Collateralised debt obligation (CDO) structure **Exhibit 1**



to high bond ratings and, hence, lower bond coupons.

For the initial CDOs to be issued, it is advisable to pool more debts by stronger local government and LGFVs, in order to give a higher credit comfort to investors. As investors are getting more familiar with the local government and LGFV credit, the proportion of stronger local government and LGFV debt in the pool can be gradually reduced. Alternatively, full or partial government credit can be employed for the CDO or an external guarantee like the SBLC can be sought.

Transaction structure **Exhibit 2**



Source: Standard Chartered Bank, Moody's

A US$632m bond repackaging transaction called "China Opportunity International Limited – Series 2017-1" was completed on March 9, 2017. The bonds were backed by a collateral pool of nine fixed rate bonds worth CNY4,310m issued by Guangdong Provincial Government, Hebei Provincial Government, Henan Provincial Government and Zhejiang Provincial Government. The transaction carries a 2.05% annual interest rate and a scheduled maturity date of November 8, 2018. Bank of China was the originator for this transaction, and there is a cross currency swap with Bank of China Shanghai Branch to mitigate the currency mismatch between the CNY denominated collateral pool and USD denominated notes.

At closing, the transaction was assigned A1(sf) by Moody's. The underlying local government and their bonds were not rated by Moody's, but Moody's assessed the credit quality of the four local governments and said the collateral average credit quality is consistent with the A1 rating. On May 25, 2017, the transaction was downgraded to A2(sf) due to the its linkage with the China sovereign rating, which was downgraded by Moody's from Aa3 to A1 on May 24, 2017.

At the time of writing, the second bond repackaging transaction called "China Opportunity International Limited – Series 2017-2" is being contemplated. The bonds will be originated by Bank of China and will be backed by a collateral pool of fixed rate bonds issued by the local governments in Anhui Province, Henan Province, Hebei Province, Shaanxi Province, Shanghai Municipality and Fujian Province.

The successful completion of the local government bond repackaging transaction provides a good template for the other originators with credit exposure to local government debt a way to mitigate the associated credit risk and recycle the capital tied up in the local government bonds. The placement of the transaction offshore proves that there is an offshore investor base with interest and credit comfort in the local government debt. The diversity of the originators and the volume of such transactions in the near future depends a lot of the approach to be adopted by China bank regulators in approving such transactions and the cost of such transactions (for instance cross currency swaps).

Collateral pool **Exhibit 3**

Bond issuer	Bond issuer code	Amount (RMBm)	Annual fixed interest rate	Maturity
Guangdong Provincial Government	1563026	320	3.02%	10/12/2018
Guangdong Provincial Government	1563033	230	2.83%	11/3/2018
Heibei Provincial Government	1543026	800	3.17%	9/21/2018
Heibei Provincial Government	1543022	870	3.18%	9/18/2018
Henan Provincial Government	1560022	840	3.02%	11/4/2018
Henan Provincial Government	1560018	400	3.02%	11/4/2018
Zhejiang Provincial Government	1552017	470	2.98%	9/18/2018
Zhejiang Provincial Government	1552025	300	2.94%	10/16/2018
Zhejiang Provincial Government	1552021	80	2.94%	10/16/2018
Total		**4,310**		

Source: Standard Chartered Bank, Moody's

Conclusion

While there remain some areas for development and improvement in China's securitisation legal framework and practice, China's ABS market continues to rapidly develop and evolve towards top international rating standards.

The large asset size of the securitisation originators in China and the ample onshore liquidity should continue the strong demand for and supply of China's domestic securitisation. Whether China's securitisation will go offshore depends on a lot of factors including, but not limited to, pricing difference between onshore and offshore securitiation, availability and pricing for cross currency swaps, the asset classes that fall into the credit comfort zone of offshore investors.

Notes:

1 Partner at Eversheds (Hong Kong), Notary Public (Hong Kong), FCIArb (Fellow of the Chartered Institute of Arbitrators), Adjunct Associate Professor at Law Faculty of The University of Hong Kong, Senior Fellow of CFRED at The Chinese University of Hong Kong, Secretary-General & Director of Asia Pacific Structured Finance Association.

2 Professor of Practice at the Department of Finance and Insurance and Department of Economics at Lingnan University, Director of Asia Pacific Structured Finance Association, Mainland Opportunities Committee Member of Financial Services Development Council of Hong Kong, and Former Head of Non-Japan Asia Structured Finance Group at Fitch Ratings.

3 We have endeavoured to state the law and state of play as at August 18, 2017.

4 See G. Ma, "Why China's haste to internationalise the renminbi?", April 11, 2014, available at: http://www.bruegel.org/nc/blog/detail/article/1301-why-chinas-haste-to-internationalise-the-renminbi/

5 "China Becomes Asia's Biggest Securitization Market", Wall Street Journal (September 24, 2015). Available at: https://www.wsj.com/articles/china-becomes-asias-biggest-securitization-market-1443082192.

6 "Consumer-related issuers set to lead asset-backed securities growth", South China Morning Post (December 21, 2016). Available at: http://www.scmp.com/business/banking-finance/article/2056334/consumer-related-issuers-set-lead-asset-backed-securities.

7 Interim Measures on the Pilot Scheme for Securitisation of Credit Assets effective on April 20, 2005.

8 By legal true sale, we refer to the situation where after such sale, the sold assets will no longer form part of the originator's estate even after the insolvency of the originator. We do not refer to accounting true sale (e.g. off-balance sheet treatment) or tax true sale.

9 Trust Law of the People's Republic of China (Zhu Xi Ling [2001] No. 50), effective on October 1, 2001.

10 See Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds (2009 Revision).

11 A securitisation originated by Dynasty Property Investment (Holdings) Limited. However, around the same time, the State Administration of Foreign Exchanges (SAFE) and Ministry of Construction (MOC) jointly issued their "Notice on Matters Related to Regulating Foreign Investments in Real Estate Market (MOC Circular 171 in 2006). This regulatory change resulted in the original structure spearheaded by the Dynasty CMBS being a one-off structure.

12 Moody's assigned its rating of Aa3 (sf) and Fitch assigned its rating of AAsf to the Class A Notes issued by Driver China One Trust, an auto loan asset backed security (ABS) transaction sponsored by Volkswagen Finance (China) Co., Ltd (VWFC).

13 The Interim Measures on the Administration of Client Assets Management Business by Securities Companies, effective on February 1, 2004.

14 Moody's, Structured Thinking: Asia Pacific, December 3, 2014, p.20.

15 See: K. Ong and A. Liu, "The influence of public law on the development of China securitization", (2015) Capital Markets Law Journal 329 at p.334 and 335 for discussion on these clarifications.

16 For further discussion on the public law issues, see: See: K. Ong and A. Liu, "The influence of public law on the development of China securitization", (2015) Capital Markets Law Journal 329.

17 Moody's: "New type of asset-backed note for China market is a credit positive", August 29, 2016 (published at: https://www.moodys.com/research/Moodys-New-type-of-asset-backed-note-for-China-market--PR_354193).

18 By the end of 2012, at least six NAFMII ABS projects were successfully launched (see Sheppard Mullin Richter & Hampton LLP, "Asset-backed note: a brand new financing instrument for non-financial enterprises in China", Lexology (December 5, 2012). Available at: https://www.lexology.com/library/detail.aspx?g=09a41989-2f3d-41b1-994c-62a50aa2979a).

19 For further discussion on the public law issues, see: See: K. Ong and A. Liu, "The influence of public law on the development of China securitization", (2015) Capital Markets Law Journal 329.

20 Clifford Chance briefing note, "Recent Developments in Assets Securitisation in the PRC" (August 2012).

21 Clifford Chance briefing note, "An Update on Recent Developments in Assets Securitisation in the PRC" (June 2013).

22 Moody's: "New type of asset-backed note for China market is a credit positive", August 29, 2016 (published at: https://www.moodys.com/research/Moodys-New-type-of-asset-backed-note-for-China-market--PR_354193).

Contact us:

Asia Pacific Structured Finance Association (APSA)

c/o Eversheds, 21st Floor, Gloucester Tower

The Landmark, 15 Queen's Road Central, Hong Kong

tel: +852 2186 3239

web: www.apsa-asia.com