

Securitization in China - overview and issues

DENTONS

Can China develop a viable cross-border securitization market?

The past year has seen a dramatic pick-up on domestic securitizations in the People's Republic of China (PRC).

This article provides an overview of the two main government-sponsored securitization schemes in the PRC - one administered by the China Bank Regulatory Commission (CBRC), the other administered by the China Securities Regulatory Commission (CSRC). The main body of the article, however, focuses on the legal, regulatory, constitutional and other issues which must be addressed before a viable public cross-border securitization market out of China can be developed.

Neither the "special purpose trust" under the CBRC scheme nor the "special scheme" under the CSRC scheme constitutes an independent legal entity with separate legal personality.

CBRC scheme

The CBRC securitization scheme first launched in 2005 pursuant to a set of administrative regulations promulgated by the CBRC and the People's Bank of China (PBOC) comprising primarily: (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). Under these regulations, banks and non-bank financial institutions licensed by the CBRC may entrust loan receivables comprising "credit assets" to a CBRC-licensed trust and investment company as trustee.

The trustee then issues asset-backed securities (ABS) in the form of trust beneficiary certificates for offering and trading on the China interbank bond market. Each such transaction requires specific approvals of the CBRC and the PBOC. The CBRC regulations rely on the PRC Trust Law (enacted April 2001) as the operative statute.

The main players contemplated by the CBRC scheme are the following:

- **Sponsor (a bank or non-bank financial credit institution)** - who originates receivables and entrusts the same to the trustee.
- **Trustee (either affiliated with a bank or independent)** - who holds entrusted receivables as trust property and issues the ABS.
- **Servicer** - who services the entrusted receivables (typically the sponsor).
- **Custodian** - who takes custody of trust funds.
- **Enhancers** - who provides external credit enhancement for the ABS.
- **Underwriter (usually a securities company)** - who arranges the consortium for underwriting of the ABS offering.
- **Securities registration and depository institution** - with whom the ABS are registered.
- **Investors** - who purchase and trade the ABS on the interbank bond market.

The trust contract entered into between the sponsor and the trustee comprises the core transaction document under the CBRC scheme. Under the Trust Law and pursuant to the trust contract: (i) the sponsor entrusts “credit assets” to the trustee for its management thereof as trust property; (ii) the trustee issues at least two classes of ABS representing undivided beneficial interests in the trust property; (iii) the senior class ABS are then offered to and purchased by investors, with the subordinate class ABS typically held by the sponsor. “Credit assets” primarily comprise receivables originated by the sponsor, but also include security interests and contractual rights relating to such receivables as well as cash arising therefrom. The trust contract also sets forth the other rights and obligations of the parties, such as purchase price and eligibility criteria for the entrusted assets, buy-back obligations of the sponsor, trustee remuneration and replacement, term and termination, etc. The trustee also enters into a servicing contract with the servicer, a custody contract with the custodian, and other subsidiary contracts as necessary, e.g., with a transaction administrator or enhancer.

The CBRC scheme refers to the trust described above as a “special purpose trust” (SPT). The SPT is not an independent legal entity. It is rather a legal concept created by the trust contract albeit with statutory sanction. Under the Trust Law, the trust property is separate from the proprietary assets of the trustee.

The CBRC scheme contemplates internal enhancements in the forms of over-collateralization, different classes of ABS, cash collateral accounts and spread accounts. It also contemplates external

enhancements in the forms of standby letters of credit, guarantees and insurance. The CBRC regulations do not mention swaps, although they are not excluded. To date, it appears that PRC domestic securitizations have generally been unhedged for interest rate and basis mismatches.

Finally, the CBRC scheme contemplates the public offering of ABS for trading on the interbank bond market. The trustee as issuer of the ABS appoints a lead underwriter, who assembles a consortium to underwrite one-off or repeat offerings. The trustee must prepare and issue a prospectus at least five working days prior to launch of the ABS offering. Required items for disclosure in the prospectus are set forth in an appendix to the CBRC regulations, which includes a requirement that the prospectus prominently states that recourse of ABS holders is limited to the trust property of the SPT. The trustee also has periodic ongoing disclosure requirements during the tenor of the ABS.

To date, some 85 domestic securitizations have been launched in China under the CBRC scheme, with some 68 transactions since 2012. Asset classes have included

The more interesting question from a securitization point of view is whether or not any particular assignment made under Article 79 constitutes a “legal true sale.”

commercial mortgage-backed securities (CMBS), residential mortgage-backed securities (RMBS), auto loan receivables, financial leases, non-performing loans (NPLs) and future flows.

CSRC Scheme

CSRC-sponsored securitization schemes have had a more checkered history.

The first CSRC securitization scheme also launched in 2005 pursuant to administrative regulations entitled *Interim Measures on Managing Client Assets by Securities Firms* (August 2005). It was perceived at the time to rival the CBRC regulations. Under the CSRC's 2005 regulations, securities companies could apply to the CSRC for approval to establish a “selective asset management plan” (so-called “SAMP”). Under a SAMP structure, a securities company could purchase receivables and other assets from non-financial institutions and manage them on behalf of investors who had entrusted funds to the securities company for the purchase. Securities backed by SAMP assets were issued by the securities company to investors and which could be traded on the Shanghai and Shenzhen stock exchanges. A handful of SAMP transactions were done. However, the structure relied heavily on third party guarantees due to perceived difficulties with legal isolation, and the CSRC discontinued the SAMP program about a year after its launch.

It was not until 2013 that the CSRC again launched a securitization scheme pursuant to administrative regulations entitled *Administrative Provisions on the Asset Securitization Business of Securities Companies* (March 2013). Under the 2013 regulations, a securities company intending to engage in the “asset

The fundamental problem, however, with both the CBRC regulations and the CSRC regulations is that they constitute “administrative regulations” and not statutory law.

securitization business” could apply to the CSRC to establish a “special scheme” whereby funds entrusted by investors to the securities company could be used to purchase receivables and other assets to be managed by the securities company. The securities company would

issue ABS to investors representing interests in the special scheme. The ABS could then be traded on the Shanghai and Shenzhen stock exchanges and other domestic markets approved by the CSRC. Another handful of transactions were done under the 2013 regulations.

The CSRC then scrapped the 2013 regulations and promulgated a revised set of administrative regulations entitled *Administrative Provisions on the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund Management Companies* (November 2014), along with companion guidelines relating to due diligence and information disclosure. The 2014 regulations largely follow the “special scheme” structure under the 2013 regulations. The biggest difference is the change of statutory underpinning for the CSRC securitization scheme -

the 2005 and 2013 regulations relied on a principal-agency entrustment concept contained in the PRC Civil Law (enacted April 1986), whereas the 2014 regulations are grounded on the PRC Securities Investment Funds Law (enacted December 2012 and made effective June 2013), which in turn incorporates the Trust Law. Another difference is the inclusion of subsidiaries of fund management companies as entities eligible along with securities companies to engage in the asset securitization business.

Under the 2014 regulations, a securities company or the subsidiary of a fund management company may, acting as “manager,” establish a “special scheme” by contract with investors. This contract would be deemed a “fund contract” under the Securities Investment Funds Law. Pursuant to the fund contract: (i) investors entrust their funds to the



At this early stage in PRC securitization, no transaction under the CBRC scheme or the CSRC scheme has yet been tested in a PRC insolvency proceeding.

manager; (ii) the manager, using such funds, purchases “underlying assets” comprising receivables and other contractual or property rights from non-financial or financial institutions; (iii) the purchased underlying assets are held with a custodian appointed for the special scheme; (iv) the manager manages the underlying assets in accordance with the terms of the special scheme contract; and (v) the manager issues ABS to investors which evidence undivided beneficial interests in the underlying assets of the special scheme. The ABS may then be traded on the Shanghai and Shenzhen stock exchanges, the inter-agency offer and transfer system of the Securities Association of China, OTC market of securities firms, and other markets approved by the CSRC. Each special scheme is limited to 200 investors. Unlike past CSRC regulations, the 2014 regulations do not require prior CSRC approval for each special scheme, but only reporting of each special scheme to the Asset Management Association of China within five working days after its establishment.

The main players contemplated by the CSRC scheme under the 2014 CSRC regulations are the following:

- **Originator (a non-financial or financial institution)** - who originates receivables, sells these along with other underlying assets to the manager, and acts as servicer for the receivables (the servicing function is not expressly provided for in the CSRC regulations but can be fairly implied).
- **Manager (a securities company that is qualified for “client asset management business” or the subsidiary of a fund management company that is qualified for “client-specific asset management business”)** - who purchases underlying assets from the originator, manages them under a special scheme, and issues ABS to investors.
- **Custodian (a commercial bank or other approved custodial institution)** - who takes custody of underlying assets.
- **Enhancers** - who provide credit enhancement to upgrade the credit rating of the ABS.
- **Investors (qualified as meeting certain asset, income, risk tolerance and other criteria)** - who entrust funds to the manager under the special scheme.

The special scheme is not an independent legal entity. It is created by contract with statutory sanction and constitutes a “fund” under the Securities Investment Funds Law. Under the Securities Investment Funds Law, the assets of a fund are separate from the proprietary assets of the fund manager and fund custodian.

Underlying assets of a special scheme are broadly defined under the 2014 regulations as “property rights or assets” over which sellers thereof have “clear ownership,”

which “generate independent and predictable cash flows” and which can be “specified.” Underlying assets include accounts receivables, creditors’ rights over leases, “credit assets” (thus overlapping with the CBRC scheme on coverage), trust beneficiary rights, property rights of an enterprise, and the actual assets of or the right to obtain proceeds from infrastructure, commercial properties and other real estate properties. Both revolving and amortizing asset pools are contemplated.

The manager under a special scheme has multiple responsibilities. These include: management of underlying assets in the interest of investors, diligence on underlying assets and on securitization participants (set forth in due diligence guidelines accompanying the 2014 regulations), payment to originators of the purchase price for underlying assets, set-up and supervision of the collection function, segregation of funds, distribution of returns to investors, information disclosures to investors (set forth in information disclosure guidelines accompanying the 2014 regulations), maintenance of separate books and records for each special scheme managed, adoption of risk control measures, and preparation of annual management reports.

Legal isolation

Trust Law

The CBRC regulations rely on the PRC Trust Law as the operative statute for achieving legal isolation of assets from the originator. The Trust Law utilizes the term “entrustment” when referring to the transfer of credit assets by the sponsor as settlor to the trustee. A question arises as to whether



such entrustment means transfer of ownership or merely transfer of possession. It is clear in the context of the CBRC regulations that this term is interpreted to mean transfer of ownership. There is an internal discrepancy, however, between the noun form of the word “trust” in Chinese (xin tuo 信託) and the verb form of the word “entrust” in Chinese (wei tuo 委託) as those terms are used in the Trust Law itself. The verb form of the term “entrust” (wei tuo) as used in the Trust Law is identical to the term “entrust” (wei tuo) as used in the PRC Civil Law and, as we shall see below, this term (wei tuo) has been interpreted under previous CSRC schemes to mean only transfer of possession but not of ownership. Obviously, if the verb form of the term “entrust” (wei tuo) under the Trust Law means transfer of possession but not ownership, then there exists a very big problem with legal isolation under the CBRC scheme, i.e., the transferred credit assets could be deemed to constitute part of the estate of the sponsor in a liquidation or bankruptcy.

PRC practitioners, however, are confident that an “entrustment”

under the Trust Law means a transfer of ownership, albeit of legal ownership only, whereas the settlor (or other beneficiaries specified in the trust contract) retains beneficial ownership. This would be similar to the result under Western common law concepts relating to trusts, and would seem to be a reasonable position to adopt in interpreting the legal effect of an “entrustment” under the Trust Law.

In any case, these problems could be readily remedied by simply combining an “entrustment” (wei tuo) transaction under the Trust Law with a concurrent “transfer” (zhuang rang 轉讓) transaction under the PRC Contract Law, which clearly means transfer of ownership. But this should be done explicitly, both in the CBRC regulations and in the transaction documents drawn up in a CBRC securitization, rather than only impliedly as has been the case to date.

If there occurs a transfer of ownership over credit assets pursuant to both a Trust Law “entrustment” and a Contract Law “transfer” under the CBRC scheme, then it appears that legal isolation

of such assets is achievable vis-a-vis the sponsor. Article 15 of the Trust Law provides that trust property shall not constitute part of the settlor’s estate so long as the settlor is not the sole beneficiary of the trust, and in all CBRC securitizations at least two classes of trust beneficiary certificates are issued, with the senior and any mezzanine certificates always paid prior to the junior certificate held by the sponsor. Article 12 of the Trust Law provides that creditors of the settlor for one year have a right to petition the court to nullify the trust if the settlor “prejudices the interests of its creditors” by establishing the trust. However, the securitization could defeat any such challenge if handled properly, e.g., by documenting that the purchase price paid by the trustee constituted fair value for the credit assets transferred.

[Contract Law](#)

The CSRC regulations rely on the PRC Contract Law as the operative statute to achieve legal isolation of assets from the originator. As seen above, legal isolation of assets from the sponsor could be fortified under the CBRC regulations as well if the Contract Law were also invoked.



Under Article 79 of the Contract Law, an assignor may “assign” or “transfer” (zhuang rang 轉讓) contractual rights (including receivables) to an assignee. Thus, under the CSRC scheme, the originator as assignor transfers receivables and other contractual rights to the manager as assignee and, under the CBRC scheme, the sponsor as assignor transfers receivables and other contractual rights to the trustee as assignee.

Article 79 on its face is clear about transfer of ownership, i.e., contractual rights thus assigned have the effect of transferring ownership, and not just possession, to the assignee. But the more interesting question from a securitization point of view is whether or not any particular assignment made under Article 79 constitutes a “legal true sale.” In other words, under what circumstances could an assignment purportedly made under Article 79 be revoked or be recharacterized as a secured loan or other type of transaction, whether

under the Enterprise Insolvency Law or under other PRC law? This question is not fully addressed in PRC legal opinions issued under either the CBRC scheme or the CSRC scheme. “Legal true sale” is simply not a familiar concept in the PRC judicial world, and thus PRC practitioners lack adequate formal judicial guidance. In unrelated memoranda provided by PRC practitioners, the concept of “legal true sale” has been discussed, where the focus has been on factors such as the intention of the parties, fair value given in exchange for the assignment of assets, the relinquishment of control over assets assigned, etc. But there seems to be a dearth of court precedents on this issue.

Article 80 of the Contract Law provides that the obligee assigning its rights “shall” or “should” (ying dang 應當) notify the obligor of the assignment, and that without such notice the assignment shall not be effective against the obligor. The most commonly asked question

about this provision is whether, even without such notice, the assignment is nevertheless still effective as between the assignor and the assignee. The consensus among PRC practitioners seems to be in the affirmative, with the condition that the obligor retains its contractual defenses (e.g., set-off rights) until notified.

Enterprise Insolvency Law

The PRC Enterprise Insolvency Law was enacted in August 2006 (subsequent to the promulgation in 2005 of both the CBRC regulations and the first CSRC regulations on securitization). It applies to all enterprise legal persons in the PRC and would thus apply to all institutions that are eligible as sponsors under the CBRC securitization scheme or as originators under the CSRC scheme, as well as to the other parties or participants in a securitization transaction.

The Enterprise Insolvency Law contains various provisions which may in some way impact the integrity of a securitization transaction. Under Article 18, the court-appointed administrator has discretion to void executory contracts at time of insolvency. A trust contract under the CBRC scheme, or a fund contract under the CSRC scheme, would be an executory contract (containing outstanding obligations on both sides) until terminated. Under Article 31, the court-appointed insolvency administrator may revoke certain types of transactions if concluded within one year prior to the court’s acceptance of the application of insolvency, specifically - gratis transfers, transactions at undervalue, guarantees of debts, debt prepayments and debt forgiveness. Under Article 32, the administrator

may revoke preferential payments to creditors made six months prior to the court's acceptance of the application of insolvency. Under Article 33, a debtor's fraudulent transactions are deemed to be invalid. Article 34 then provides for clawback as the remedy for the foregoing types of transactions. Under Article 54, a trustee also has creditors rights against the debtor as settlor for dealings in good faith with the debtor.

Apart from the specific statutory provisions in the Enterprise Insolvency Law described above, it may also be reasonable to ask what discretionary or equitable powers might be accorded to an administrator or to the court in an insolvency proceeding. For example, could a sale be recharacterized as a secured lending, and what factors might be relevant for, or increase or decrease the risk of, such a discretionary determination?

It seems that, with proper structuring, lawyering and drafting, most if not all of the foregoing issues could be resolved or managed to an acceptable degree of legal risk. However, at this early stage in PRC securitization, no transaction under the CBRC scheme or the CSRC scheme has yet been tested in a PRC insolvency proceeding, and legal opinions issued on PRC securitization transactions do not squarely address many of the aforesaid issues under the Enterprise Insolvency Law.

Commingling

Trust Law

Article 16 of the Trust Law provides that trust property shall not constitute part of the trustee's estate in a bankruptcy of the trustee. Article 18 provides that the claims of a trustee arising from its management

of trust property shall not be used to offset the liabilities arising from the trustee's proprietary assets.

The CBRC regulations extend this non-commingling treatment in respect of the trustee to all other parties of a securitization transaction. Article 6 of the CBRC regulations states that the trust property of a "special purpose trust" are "separate" from the proprietary assets of the sponsor, trustee, servicer, custodian and other parties to the securitization transaction, and do not constitute part of the estates of such parties upon their liquidation or bankruptcy. However, the CBRC regulations are administrative regulations and not statutory law, and such issues could only be more dispositively determined by an insolvency court having jurisdiction over such parties.

Securities Investment Funds Law

Article 5 of the Securities Investment Funds Law provides that the assets of a fund shall be "independent" of assets owned by the fund manager and the fund custodian, and that assets of a fund shall not be deemed part of the assets of the fund manager or fund custodian in the event of their liquidation or bankruptcy.

Article 5 of the CSRC's 2014 regulations provides that the assets of a special scheme shall be "independent" of the proprietary assets of the originator, manager, custodian and other participants of a special scheme, and that the assets of a special scheme shall not constitute part of the estates of such parties upon their liquidation or bankruptcy. Again, the CSRC regulations are administrative regulations rather than statutory law, and they attempt to extend application of the Securities

Investment Funds Law to participants not contemplated by that statute, with no court precedents on point.

Civil Law

In the case of the CSRC scheme, the issue of ownership of fund assets (i.e., "underlying assets" of the "special scheme") might also be addressed in the context of commingling. This is because, if it can be shown that ABS investors legally own the underlying assets, even in the context of a bankruptcy or liquidation of a securitization participant, then the issue of commingling might to some extent be mitigated.

The PRC Civil Law is based on the German Civil Code. Its provisions are fundamental to civil relations in China and fairly well established. For the entrustment of funds by ABS investors to the manager, the previous CSRC schemes (under the 2005 and 2013 regulations) have relied on Article 64 et. seq. of the Civil Law, which provides for an "entrusted agency" (wei tuo dai li 委託代理), creating a principal-agency relationship between the investor as principal and the manager as agent. In an "entrustment" (wei tuo) pursuant to Article 64 of the Civil Law: (i) the entrustor (as principal in the relationship) retains ownership of the assets entrusted; and (ii) the trustee (as agent in the relationship) acquires possession but not ownership of the assets entrusted, i.e., the trustee holds the entrusted assets on behalf of the entrustor as owner thereof. Under the previous CSRC schemes, PRC practitioners have asserted that, under Article 64 of the Civil Law, the ownership of all underlying assets held in a special scheme in whatever form (entrusted funds, purchased receivables, proceeds

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arising from receivables, etc.) would remain with the ABS investor, even in a bankruptcy or liquidation of the manager or other securitization participants. Such treatment would be similar to the concept of “client money” in a Western bankruptcy proceeding. This result, of course, has yet to be tested by a PRC insolvency court under the Enterprise Insolvency Law.

Arguably the same result still could be achieved for transactions under the current CSRC scheme. The 2014 regulations are promulgated pursuant to, inter alia, the Securities Investment Funds Law and “other relevant laws and regulations.” The text of the Securities Investment Funds Law does not explicitly address ownership of fund assets. Article 2 of the Securities Investment Funds Law states that “with respect to matters which are not covered by the provisions herein, the provisions [inter alia] of the Trust Law shall apply.” As discussed above, entrustment (wei tuo) under the Trust Law might not mean transfer of ownership but of possession only, although the better view is probably that legal ownership is transferred whilst beneficial ownership is retained. However, the 2014 regulations are also premised on “other laws and regulations.”

It thus appears that parties to a fund contract are free to invoke entrustment under the Civil Law (i.e., to keep the “client money” theory adopted under the CSRC 2013 regulations) if they wish to do so in order to mitigate commingling risk.

Bankruptcy remoteness

There is a long-standing confusion in the PRC securitization market with respect to the use of the term “bankruptcy remoteness.” Often, parties and practitioners in the PRC will describe a transaction as being “bankrupt remote” even when there is no special purpose vehicle or other intermediary concept involved. Of course, this term is used in Western securitizations to describe the integrity of the special purpose vehicle.

It should be noted that neither the “special purpose trust” under the CBRC scheme nor the “special scheme” under the CSRC scheme constitutes an independent legal entity with separate legal personality. They are creatures of contract, albeit with statutory sanction. As such, there is no legal entity that could become insolvent or undergo bankruptcy proceedings should there be insufficient assets to meet obligations. However, the concept of “bankruptcy remoteness” could still make sense if understood to mean the integrity of the “special purpose trust” or the “special scheme” to adhere to and perform the trust contract and fund contract, respectively, in accordance with their terms, in the event of a default under the securitization transaction or in the event of a liquidation or bankruptcy of one of the securitization parties or participants.

Rather than “bankruptcy remoteness” per se, the more proper and precise questions to raise are the following:

- **Under the CBRC scheme:** (i) does the assignment of assets by the sponsor to the trustee constitute a “legal true sale”; (ii) what is the risk of clawback or recharacterization under the Enterprise Insolvency Law in respect of the assignment; and (iii) what happens with assets commingled with the proprietary assets of parties to the securitization transaction (other than the trustee) in the event of a liquidation or bankruptcy?
- **Under the CSRC scheme:** (i) does the assignment of assets by the originator to the manager constitute a “legal true sale”; (ii) what is the risk of clawback or recharacterization under the Enterprise Insolvency Law in respect of the assignment; (iii) who owns the funds entrusted by investors to the manager (including the underlying assets purchased with such funds and the income arising therefrom); and (iv) what happens with assets commingled with the proprietary assets of participants of the special scheme (other than the manager and custodian) in the event of a liquidation or bankruptcy?

Constitutional law

As with many financial initiatives in China, the CBRC and CSRC schemes are fairly new, and as such untested or inadequately tested in PRC courts. Even were there to occur an insolvency of a key securitization party or participant (e.g., the sponsor or the manager) that was adjudicated by a PRC court in favor of the integrity of the securitization scheme, there is no stare decisis in the PRC. In other words, PRC court precedents are generally not binding as judge-made law, unless selected as a binding precedent by

the Supreme People's Court. Even in that event, the PRC judiciary does not have final power to interpret the laws. Under Article 128 of the PRC Constitution, the Supreme People's Court is responsible to the National People's Congress (NPC) and to the NPC Standing Committee. Under Article 67 of the PRC Constitution and under Article 42 of the Legislation Law, the NPC Standing Committee has the final power to interpret the laws, and legislative interpretations issued by the NPC Standing Committee shall have the same force as law. In Western terms, there is, in the PRC, a lack of "judicial independence" and a breach of "separation of powers" not only in practice but hard-wired into the PRC constitution.

The fundamental problem, however, with both the CBRC regulations and the CSRC regulations is that

they constitute "administrative regulations" and not statutory law. In both civil law and common law jurisdictions, a statute trumps an administrative regulation and, given a conflict or inconsistency between the two, the statute prevails. However enlightened or forward-looking the CBRC and CSRC regulations may be, from a constitutional point of view it is a case of "sending a boy to do a man's job." This is especially risky where, as observed above, the judiciary does not have the power to make final and dispositive interpretations of the relevant statutes. This is not necessarily to say that the CBRC and CSRC schemes don't work. It is, however, warranted to say that the statutory grounding for all transactions done pursuant thereto must be made explicit and crystal clear, particularly in light of the fact that the PRC is a civil law jurisdiction.

Related laws and regulations

Securitization players in the PRC commonly encounter a number of legal or regulatory issues which are challenging for practitioners. Below is a brief description of some of the more material challenges.

Under the Security Law and Property Rights Law, mortgages over "immovables" (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 poses challenges where real estate mortgage loans are being securitized. If re-registration of real estate mortgages in favor of the trustee, manager or other transferee is contemplated either prior to or after enforcement, then commercial mortgage-backed securities (CMBS) transactions would be more feasible





than residential mortgage-backed securities (RMBS) transactions, due to the sheer number of re-registrations involved in respect of the latter. On the other hand, ABS transactions backed by mortgage-secured auto loans or leases may be quite feasible from the aspect of transferring rights in collateral.

Also, under the Security Law and Property Rights Law, it is not technically possible to create a security interest over a bank account. The closest equivalent is a type of security right known as a “deposit,” which gives control only over one-third of funds deposited in any particular account. The Western concept of “lockbox accounts” is therefore not available in the PRC as a way for buy-side parties to control cash, and other arrangements must be made, such as diversion of funds paid by obligors on day one.

There is a general question in the PRC as to whether “future flows”

can be securitized. The consensus among practitioners seems to be in the affirmative, so long as future receivables are evidenced by an underlying contract (e.g., a rental agreement). However, there is no reliable court precedent on this issue.

Third party servicing (e.g., by a backup servicer or special servicer) can be an issue. Different regulators in the PRC impose different restrictions on debt collection by an entity that did not originate or that does not own the receivables being collected. Enforcement of such restrictions also seems to be inconsistent, depending on the region where servicing functions are carried out.

For banks and non-bank financial institutions, the CBRC has imposed numerous restrictions on the transfer of “credit assets,” referring to receivables generated by these CBRC-regulated entities. No such restrictions, however, have generally

been imposed by the CSRC on receivables generated by entities not regulated by the CBRC. Outside of express CBRC sanction, it is thus more difficult to securitize receivables which constitute “credit assets” (e.g., bank loan receivables) than those which do not (e.g., trade receivables or rental receivables).

Despite various liberalizations on foreign exchange controls and the PRC government’s policy of internationalizing the renminbi (RMB), the RMB remains a tightly-controlled currency. Any true cross-border securitization under either the CBRC or CSRC scheme would require prior approval of the State Administration for Foreign Exchange (SAFE) in relation to all cross-border remittances of funds relating to the securitization.

Finally, any cross-border securitization would require a cross-currency swap. In the realm of OTC derivatives, however, the PRC

remains isolated from international norms and conventions. For all domestic swaps, the PRC uses its own master agreement written in Chinese, governed by PRC law and published by the PRC National Association of Financial Market Institutional Investors (the so-called NAFMII master agreement). For cross-border swaps utilizing the ISDA master agreement, the International Swaps and Derivatives Association (ISDA) still considers the PRC to be a “non-netting jurisdiction” due to uncertainties about the treatment of close-out netting under the PRC Enterprise Insolvency Law. PRC banks have also been slow in getting to grips with international swaps regulations, such as Title VII of the U.S. Dodd-Frank Act and the European Market Infrastructure Regulation (EMIR).

Conclusions

From a legal point of view, the single best thing that could happen for a securitization market to develop in China, for both domestic and cross-border transactions, is for the NPC to enact a securitization statute. Other civil law jurisdictions in Asia, such as Korea, have done this. Particularly for a jurisdiction such as China, which is a civil law jurisdiction, and where “rule of law” in certain areas is not yet firmly established, a securitization statute would be a great help. Such a statute should be a “special law” that can override other statutes of more general application (such as the Enterprise Insolvency Law and the Property Rights Law) at key inconsistent or unclear points. Such a statute should also fill in critical gaps in a typical securitization, e.g., it could provide for “special purpose vehicles” and “lockbox accounts.”



From a regulatory point of view, the best thing that could happen is for the CBRC and the CSRC, along with other financial regulators, to cooperate in creating a single national securitization scheme. Such a scheme could utilize both the Contract Law and the Trust Law in combination to achieve legal isolation of receivables and other assets upstream. It could then make available all relevant PRC laws and regulations (including the Securities Law, the Securities Investment Funds Law and the Civil Law) for offering and trading of ABS on stock exchanges and OTC markets downstream. Short of a special securitization statute, this is probably the best “pseudo-securitization” achievable under existing PRC laws and regulations.

In the meantime, practitioners will be focusing on private structured finance solutions for clients, applying international securitization technology within the existing PRC framework.

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