China securitisation comes of age

By Mark Story

Given the size of China's domestic market and the regulatory framework now in place to support it, remarkably few transactions have been completed since the Pilot Measures (on the securitisation of loan assets) were enacted back in April 2005.

Regulations jointly issued by the People's Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC) saw a handful of asset securitisation companies take over non-performing assets from banks and public financial institutions during the first stage Pilot Project.

But according to Michelle Taylor, specialist in structured finance at Orrick, Herrington & Sutcliffe in Hong Kong plans by the PRC government to widen investment criteria governing who's entitled to hold securitised notes, should help to bring a lot more deals to the table.

Since China has provided a blue-print for securitisation of loan assets (through these Pilot Measures), Taylor says what's now needed is greater acceptance over which institutions and investors are now entitled to hold securitised notes. "The Pilot Measures have been a great help, as have recent attempts to clarify related laws, including those relating to taxation and bankruptcy," says Taylor. "The government is now seeking to broaden the investor base to permit more institutional investors (such as insurance companies) to invest in securitized notes."

There is clearly no lack of assets or lawyers available to securitise them across mainland China. Legal know-how remains concentrated around Beijing and Shanghai, especially for banking and property-related securitisations. The most prominent players in China's domestic securitisation market are law firms: Zhong Lun, King and Wood, Global, Allbright Law Offices, and Freshfields; and financial institutions like Standard Chartered Bank.

Anecdotal evidence that existing laws appear to be functioning 'relatively' well belie clarion-calls for China to adopt securities law with UK or US-style uniformity. But Yang Xusheng, a partner at King and Wood's Beijing office agrees with Taylor, there is still sufficient room for improvement. For example, he says several legal issues requiring resolution concerning loan assets securitisation practice (under the current Chinese legal framework) include areas relating to: Notification for the creation of Trusts, replacement and redemption of non-confirming assets, registration of the change of mortgage or pledge for loan assets, and the extent of information disclosure.

Yet with regulatory authorities preoccupied with introducing extra deals to the market, he says it could be years before (additional) serious legislative reforms are implemented.

A new bankruptcy law, effective 1 June this year follows greater guidance on tax provided by the National Tax Bureau two years ago - and more recently - changes to both property law, and regulations governing trusts.

On the heels of these developments the China Securitisation Forum *(www.chinasecuritization.org)* is now aiming to draft the ABS (Asset backed Securities) Regulations requested by the regulators to sort out these ongoing legal hurdles. Law Firms Mayer, Brown, Rowe & Maw LLP, and Zhong Lun have been appointed exclusive legal service providers and coordinators of the draft law.

Meantime, the PRC State Council recently granted RMB 60 Billion Yuan for the second stage ABS pilot project. It's understood the PBOC would like to exhaust this RMB 60 Billion Yuan quota by March of next year. But with China equities running red hot right now, Yang says it remains unclear if the present market has the capacity to complete this many deals.

Liu Borong, partner of Zhong Lun Law Firm, told *ALB (China)* there are no fewer than 10 deals in varying stages of completion under the second ABS pilot project. These include: Six PRC banks preparing CLO projects, one PRC bank's CMBS project, one automotive finance company is preparing an Auto Loan ABS project, one bank is initiating the second RMBS project, a bank credit card securitisation project, and PRC bank's non-performing loan securitisation is also under discussion.

"There are a lot of different arrangements for the second stage ABS pilot project compared with deals done under the first stage. These include set-off issues, co-mingling issues, and liquidity issues." says Liu Borong who's also Secretary-General of the China Securitisation Forum and Chairman of the Asset Securitisation Commission of the Beijing lawyer Association.

"The regulators appear willing to diversify the structure and asset class of the deals that are done under the second stage ABS pilot project."

Given the short time frames within which deals are being brought to the table for execution, Yang says the banks and non-bank institutions driving them will want to engage law firms that are already familiar with the pilot projects.

As a result, he suspects this may limit the number of deals that can be completed at any one time. "As these deals tend to be more intricate, clients will look for experienced lawyers who can guide them through more complex transactions," says Yang whose firm provided counseling for the first CMBS securitisation project supported by China's properties in Asia.

However, pricing for legal fees in China means some legal experts are reluctant to take on more domestic securitisation deals under the second stage ABS pilot project. Because they're 'law intensive', require a lot of research, and require considerably more investigatory input than a cookie-cutter solution, Clive Rough managing partner of Freshfield's Hong Kong office advised *ALB (China)* his firm was unlikely to do any more securitisation deals (in mainland China). Freshfields was part of the legal team responsible for the China Construction Bank's (CCB) notable US$380 million domestic residential mortgage-backed securitisation deal completed under the stage one ABS pilot project.

"There's a lot of excitement to do these deals, but no one wants to pay good money for legal fees in China – so we won't be racing to do any more of them," says Rough who's firm has advised on many high-profile transactions since securitisation first came to Asia 12 years ago.

As ABS pilot measures were specifically designed to help China navigate its way through the first batch of securitisation deals, Yang says it's hardly surprising deals done under stage one took up to two years to complete. But with much of the legal structural framework having been defined (through the stage one ABS Pilot project), he expects deals being completed during stage two to be executed a lot quicker.

Until this year's quota is used up, it remains unclear whether there's likely to be a third batch of ABS pilot projects in 2008. But given the demand for securitisation that's likely to come from bank loans, mortgages, and institutions offering credit cards – plus property market deals within the next few years - Taylor expects significant growth in domestic securitisation throughout China.

On the cross-border front, Taylor says follow-up deals to the landmark (nine properties) Dynasty Asset Holdings CMBS deal she helped to execute, appear problematic at best.

While real estate is arguably one of China's real 'hot buttons' the method of ownership is an even harder hurdle to jump than ever. Taylor says while the Dynasty CMBS deal was supposed to be the first of many there are now added complications. She claims increased difficulty of foreign companies owning assets in China makes cross-border securitisation akin to a ‘chicken and egg’ dilemma. In other words, if you can’t acquire, then you can’t subsequently securitise.

Not surprisingly, domestic developers and international banks have invested a lot of time exploring the structures under which CMBS could be executed. Nevertheless, Taylor still expects there to be more CMBS deals this year and in 2008, and advised *ALB (China)* that her firm is currently working on some deals based in mainland China. Owing to the nature of these deals, she expects most CMBS deals to be executed by lawyers and bankers based in Hong Kong.

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