

# ASSET-BACKED SECURITIES IN CHINA

## Chapter-1

### Introduction

Securitisation, in its most basic form, is the repackaging of asset cash flows into securities. It means legally isolating sources of cash flow from avoidable risk, and issuing debt backed by this revenue. Securitisation is a pooling of “homogeneous”, “financial”, “cash flow producing”, “illiquid” assets and issuing claims on those assets in the form of marketable securities. The higher yield associated with these securities attracts investors who are willing to bear incremental credit, prepayment and liquidity risk. The fundamental principle in securitisation is specific identification of risks and allocation of the same to various parties who are best able to manage those risks.

Securitisation is the process by which, financial assets such as household mortgages, credit card balances, hire-purchase debtors and trade debtors, etc., are transformed into securities. In present day capital market usage, the term is implied to include securities created out of a pool of assets such as household mortgages, credit card balances, hire-purchase debtors and trade debtors, other receivables, etc., transferred, fully or partially, which are put under the legal control of the investors by the owner (the Originator) in return for an immediate cash payment and/or deferred consideration through a Special Purpose Vehicle (SPV) created for this purpose. The Special Purpose Vehicle finances the assets transferred to it by the issue of debt securities such as loan notes or Pass Through Certificates, which are generally monitored by trustees. Pass Through Certificates are certificates acknowledging a debt where the payment of interest

and/or the repayment of principal are directly or indirectly linked or related to realisations from securitised assets.

Arrangements are made to protect the holders of the debt securities issued as above by the Special Purpose Vehicle from losses occurring on the securitised assets by a process termed as 'credit enhancement', which may take the form of a third party insurance, a third party guarantee of the Special Purpose Vehicle's obligations or an issue of subordinated debt. The Originator may continue to service the securitised assets (i.e., to collect amounts due from borrowers, etc.) and receive servicing fees for the same. The Originator may also securitise the future receivables, i.e., the receivables that do not exist at the time of agreement but would be arising in future.

Let us consider an example:

A finance company with a portfolio of car loans can raise funds by selling these loans to another entity. But this sale can also be done by "securitising" its car loans portfolio into instruments with a fixed return based on the maturity profile (the period for which the loans are given). If the company has Rs 100 crore worth of car loans and is due to earn 17 per cent income on them, it can securitise these loans into instruments with 16 % return with safeguards against defaults. These could be sold by the finance company to another if it needs funds before these loan repayments are due. The principal and interest repayment on the securitised instruments are met from the assets which are securitised, in this case, the car loans. Selling these securities in the market has a double impact. One, it will provide the company with cash before the loans mature. Two, the assets (car loans) will go out of the books of the finance company once they are securitised, a good thing as all risk is removed.

Since the late 1990s, China has been viewed as distinct among East Asian economies in having avoided severe disruption due to financial crisis. It is certainly the case that China, by virtue of its relatively closed and government-directed financial system, has escaped destabilizing swings in the value of its currency, liquidity pressures on its reserve base, and failure of its banking institutions. However, it should not be overlooked that China, when measured by its sizable volume of distressed or non-performing loans (NPLs), its large number of poorly performing state-owned enterprises

(SOEs), and its underdeveloped and still repressed capital markets, is in fact plagued by many of the ills that have afflicted the crisis countries.

To its credit, China's government, as part of its broader and continuing efforts at economic restructuring, has taken active measures to address these matters in a systematic manner. In this regard, the February 1, 2004, statement by the State Council of the Peoples' Republic of China (PRC), reasserting its objective to reform and develop China's capital markets, is emblematic. The announcement opens the path for a new legal framework to support China's securities markets, including formal implementation as a function of the parallel development of specific securities and banking regulations.<sup>1</sup> While the contribution of the former is obvious, that of the latter--banking regulation--may be more ambiguous. In terms of capital markets, banks can have several direct functions, most notably lending, payment settlement, and custody. Often overshadowed, but no less important, however, is the informational role of banks, particularly in emerging financial systems in which information structures are themselves evolving. It is then the primary objective of this paper to present the case of complementarity in banking and securities markets by focusing on the informational role of banks in support of securities market operations. Secondly, to maintain specificity and detail, the focus is on the analysis of China's prospective markets for asset-backed securities (ABS). By way of definition, the term asset securitization is being used to refer to the process whereby otherwise illiquid assets are packaged and sold to specially created, single purpose companies, which in turn issue securities, either publicly or privately, backed by those assets.<sup>2</sup> Structured finance extends this basic logic to include the separation of securities into classes or tranches, which are sold to investors with differing appetites for risk<sup>3</sup>. In Asia, ABS markets have expanded rapidly in the wake of enabling legislation enacted in the early 1990s, but might still be characterized as developmental. This is certainly more so the case in China, where the required legal infrastructure is ambiguous

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<sup>1</sup> Capital Market Reform Expected," Xinhuanet, February 3, 2004, <  
[http://news.xinhuanet.com/english/2004-02/03/content\\_1295891.htm](http://news.xinhuanet.com/english/2004-02/03/content_1295891.htm)> (accessed December 2004).

<sup>2</sup> Laskshman Alles, "Asset Securitization and Structured Financing: Future Prospects and Challenges for Emerging Markets," IMP Working Paper WP/01/147, October 2003.

<sup>3</sup> *ibid*

at best and nonexistent at worst--and where few securitized transactions have been sourced.

Barriers to the successful development of ABS markets in Asia are, on their highest plain, consistent with constraints on public debt markets more generally: the lack of market-determined government bond rates, limited supply, pressures on demand owing to statutory restrictions, poorly developed information structures, and trade clearing and settlement processes, etc.<sup>4</sup> From a regulatory perspective, ABS markets are also strapped by the requirement for a specialized legal framework that allows assets to be formally transferred from the seller (the "originator") to the special purpose company (SPC), to be used as a source of cash flows by that entity in the issuance of securities, and to be managed or serviced for the benefit of the securities holders. From a financial market perspective, the successful development of ABS markets further requires a large supply of financial assets either of high quality or of sufficient homogeneity with respect to their inherent risk and the predictability of their cash flows. Such a scenario allows for the creation of a steady stream of payments capable of meeting the debt service requirements of the issued securities with relatively little risk. As with many in East Asia, China's financial system is bank-centered. The recent evolution in Chinese finance begins with the budgetary allocations of a command economy, moves to the allocative controls of a state-owned banking regime, and finally to the provision of competitive, commercially-based banking services. Thus, bank loans are by far the most dominant source of funds to the Chinese financial system, constituting more than 80 percent of the annual increase in average fund flows for the last three years<sup>5</sup>. Furthermore, and notably for the present context, approximately 20 percent of Chinese bank loans (2002) are considered non-performing by international standards, the equivalent of about 20 percent of China's GDP.<sup>6</sup> Such a high concentration of financial assets in a single class, burdened further by suspect quality, severely hampers building the diversified pools of assets required for effective securitization. Moreover, where the benefits of securitization in the form of asset management, liquidity, and capital management flexibility would otherwise accrue

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<sup>4</sup> S. Ghon Rhee, "Institutional Impediments to the Development of Fixed-Income Markets: An Asian Perspective".

<sup>5</sup> See Annexure

<sup>6</sup> Luo Ping, "Challenges for China's Banking Sector and Policy Responses," China Banking Regulatory Commission, New Delhi, November 14-16, 2003

to China's banks, their distressed loans, in at least this respect, imprison them.

## *Research Methodology*

### **Objectives:**

1. Transition from a bank-centric financial system to asset-backed finance and outlines the relationship of banks to the development of ABS markets in
2. Structural features of China's prospective ABS markets from a comparative regional perspective.
3. The impact of China's NPL problem on finding effective ABS solutions.
4. Complementarily relationship between banking and capital market finance through the informational role of banks in developing ABS markets in China.

### **Research Questions:**

1. How shall China disentangle itself from this web of capital market underdevelopment buttressed by a weak commercial banking sector?
2. How NPLS problem can be tackle by Chinese markets by implementing the process of asset-backed securities?

### **Research Methodology:**

The methodology used here will be deductive i.e. after the literature survey a critical overview will be presented and since the topic is constrained with materials the researcher will have to give innovative concepts in the project.

### **Sources:**

1. Books
2. Websites
3. Journals
4. Articles



## Chapter-2

# THE CAPITAL MARKET ROLE OF BANKS: BENEFITS AND COSTS

Unlike other banking systems, particularly those of Northeast Asia, China's is not in the tradition of the Japanese "main bank" or even necessarily the South Korean "principal transactions bank."<sup>7</sup> Instead, China's banks were long ago tasked explicitly with supporting the development goals of the Chinese state as affected though China's SOEs and as such were required to undertake direct lending on policy rather than commercial terms<sup>8</sup>. This began to change in 1994 with the introduction of specialized banks to conduct policy-specific lending; in 1995, with the promulgation of China's Commercial Banking Law; and in 1999 with the establishment of China's Asset Management Companies (AMC) to relieve banks of non-performing policy loans.<sup>9</sup> What has been slower to evolve, however, is the emergence of a "risk culture" of commercial lending. This is a key underlying condition necessary for capital market reform and development to proceed in China. The process of financial development generally involves a progression from bank finance to market finance. In many countries, one can discern a growth path that begins with the expansion of bank assets relative to GDP and proceeds through the introduction and development of non-bank financial institutions

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<sup>7</sup> Masahiko Aoki, Hugh Patrick, and Paul Sheard, "The Japanese Main Bank System: An Introductory Overview," in Masahiko Aoki and Hugh Patrick, *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economics* (New York: Oxford University Press, 1994), 1-50; and Sang-Woo Nam and Dong-Won Kim, "The Principal Transactions Bank in Korea," *Ibid.*, 450-493.

<sup>8</sup> Sayuri Shirai, "Bank's Lending Behavior and Firm's Corporate Financing Pattern in the People's Republic of China".

<sup>9</sup> Nicholas Lardy, *China's Unfinished Economic Revolution* (Washington, DC: Brookings Institution Press, 1998).



(e.g. insurance companies, investment banks, pension funds, venture capital firms), which accompany and foster the growth of financial markets.<sup>10</sup> Throughout the development process, banks compete with market actors on the basis of risk management and relative returns<sup>11</sup>. In fact, despite such competition and the growth of market finance relative to bank finance, the very development of capital markets, particularly those for public debt, can contribute to the competitive posture of banks. Indirectly, the existence of liquid, local currency bond markets, with broad, well-established pricing across all maturities, supports the establishment of "risk-free" government base rates off which other assets, including bank loans, may be effectively priced.<sup>12</sup> Of particular relevance is the role of these reference rates in the pricing of derivative securities for currencies, interest rates, and credit risk, each allowing banks better control over and management of portfolios of assets and liabilities. Directly, public debt markets afford banks, as well as non-financial corporations, an additional source of capital and permit banks to better manage their capital and liquidity requirements, while broadening their exposure to market discipline. Also of relevance in the present context is that public debt markets facilitate the securitization of bank assets and allow banks better command over the management of their loan portfolios, including the disposition of NPLs. Finally, well-functioning public debt markets, in the event of a banking crisis, provide an alternative source of corporate funding and may serve to alleviate pressure on the financial system and allow for a more ordered approach to bank restructuring with reduced economic dislocation. The focus is on the informational role of banks in capital market finance, with particular reference to their monitoring clients, and considers the means by which reliable information about borrowers is

#### 1) Produced and conveyed to the capital markets and

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<sup>10</sup> Ross Levine, "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature* 35 (2) (June 1997): 717.

<sup>11</sup> See Franklin Allen and Douglas Gale, *Comparing Financial Systems* (Cambridge, MA: The MIT Press, 2003), especially Chapter 6.

<sup>12</sup> References in this paragraph were derived from Richard J. Herring and Nathporn Chatusripitak, "The Case of the Missing Market: The Bond Market and Why It Matters for Financial Development," 30-40.

2) Employed to reduce problems associated with incomplete information or conflicts of interest between borrowers and bondholders.

In developed capital markets, information production and dissemination may take several forms, including regulatory disclosures, security analyst reports, rating decisions, and media reporting. Each of these differs in the nature of the information consumed and produced, but generally share the use of borrower-disclosed data, publicly available data, or information otherwise developed by the institution. Banks, conversely, enjoy access to proprietary information about borrowers, which affords them an informational advantage. The basis of this advantage is the bank's relationship with its client through the lending agreement.

Typically, bank lending is governed by defined covenants; it provides for funds to be advanced and retired on a short-term schedule; and it is collateralized.<sup>13</sup> Each of these features contributes to the informational advantage of the bank vis-à-vis its clients and other creditors and in fact operationalizes the bank's monitoring of the borrower<sup>14</sup>. Beyond simply collecting and processing information about their clients, banks also take discrete credit actions (e.g. initiation, cancellation, extension, or renewal), which are observable by other investors and creditors. In this way, new or extended credit by a lending bank may certify managerial quality and signal positive private information about the borrower to other creditors.<sup>15</sup> In contrast to bank loan agreements, the constraints on managerial discretion imposed by bonds are comparatively narrower in scope<sup>16</sup>. As such, they often share a spectrum of the banks' monitoring regime defined by the broader and tighter covenants of the loan agreement. Furthermore, unlike bank lenders, bondholders are less concentrated and do not enjoy direct access to private information about the firm, nor the individual incentive to monitor. Thus, they can directly benefit from bank

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<sup>13</sup> Christopher James and David C. Smith, "Are Banks Still Special? New Evidence on Their Role in the Capital-Raising Process," *Journal of Applied Corporate Finance* (Spring 2000): 52-63.

<sup>14</sup> *ibid*

<sup>15</sup> S. Ghon Rhee and G. Hwan Shin, "Relation between Bank Monitoring and Firm Value Creation: A Survey," K.J. Luke Working Paper, September 2003.

<sup>16</sup> Yakov Amihud, Kenneth Garbade, and Marcel Kahan, "A New Governance Structure for Corporate Bonds," *Stanford Law Review* (February 1999).

oversight of the borrower along the shared spectrum. In this way, banks can indirectly provide information services to other lenders and in so doing influence the costs of public debt issuance.<sup>17</sup> What is important to emphasize at this juncture is that effective bank oversight, to the extent it benefits bondholders, rests squarely on the quality, financial soundness, and reputational integrity of the bank. This is critical because the features of the lending agreement that give effect to monitoring and governance, specifically the short-term nature of the agreement and the restrictive covenants that constrain managerial actions and contribute to the bank's informational advantage, also give banks considerable leverage over debtors. This leverage can expose borrowers to self-interested behavior by banks. To illustrate, given the short-term nature of the bank contract, banks can exert control over clients by demanding repayment of project loans or by requiring higher fees when continuing projects is efficient.<sup>18</sup> These actions leave borrowers exposed to potential liquidity risk, which in turn jeopardizes bondholders and other creditors and ultimately leads to higher capital costs. The problem is further accentuated when a bank's own financial condition is weakened. In this regard, the effects of recent bank distress among China's neighbors is demonstrative; in both Japan and Korea<sup>19</sup> changes in the value of bank clients can be traced directly to specific events affecting the value of their primary lenders. Conversely, weak banks, in order to avoid default, may allow borrowers to continue poor quality projects by not calling loans or by providing additional funding. To the extent that the bank's debt is senior to that of other creditors, failure to discipline management by retiring questionable credits may result in deterioration of the value of the subordinated debt, again jeopardizing the wealth of other creditors.

In good financial states, therefore, banks and capital markets coexist as competitive complements: markets offer banks access to capital, liquidity, and the ability to manage

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<sup>17</sup> Sudip Datta, Mai Iskandar-Datta, and Ajay Patel, "Bank Monitoring and the Pricing of Corporate Public Debt," *Journal of Financial Economics* 51(3) (March 1999): 435-449.

<sup>18</sup> Raghuram G. Rajan, "Insiders and Outsiders: The Choice between Informed and Arm's-Length Debt," *Journal of Finance* Vol. 47 (4), (September 1992).

<sup>19</sup> Kee-Hong Bae, Jun-Koo Kang, and Chan-Woo Lim, "The Value of Durable Bank Relationships: Evidence from Korean Banking Shocks," *Journal of Financial Economics*, 64 (2) (May 2002): 181-214.

risk, while banks, in leveraging their informational advantage to service clients, extend informational services, even if indirectly, to other capital market participants. However, and most importantly, when bank health is at risk, the banks' informational advantage may be a source of risk to bondholders and other creditors.

### Chapter-3

## BANKS AND THE DEVELOPMENT OF ABS- MARKETS

As one component of a developed regime of financial market debt, securitized finance offers several benefits to borrowers; primary among these is the ability to convert illiquid assets, such as bank loans, into a ready source of capital. Furthermore, through a well-structured securitization program, the risk of a bank's assets can be disaggregated into its constituent components-- credit risk, interest rate risk, liquidity risk--and managed more effectively. Thus, through securitized transactions, Chinese banks would be able to actively manage their loan portfolio against their capital base in order to free up capital to support increased lending.<sup>20</sup> Alternatively, securitization may serve as a source of enhanced liquidity for banks should they swap illiquid assets, such as corporate loans, commercial mortgages, or, on a retail level, residential mortgages, credit card receivables, or auto loans for liquid, investment grade securities that can be sold in secondary markets.<sup>21</sup> Lastly, though constrained by factors, securitization may also afford Chinese banks the means to dispose of assets of questionable quality. Accordingly, the banks are among the most likely to benefit from access to markets for securitized finance. Of course, as with the emergence of debt markets more generally, the challenge posed to banks by the development of local markets for securitized finance is one of competition for quality credits and lending services. In two important respects then, securitization can be viewed as accelerating the eclipse of bank finance. First, securitization allows holders of assets to by pass traditional lending banks and to acquire capital directly in the markets, using the cash flows of the securitized assets to service the issued securities. Accordingly, in lieu of a bank loan, a non-bank borrower holding a clearly defined,

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<sup>20</sup> Ian H. Giddy, "Asset Securitization in Asia," (New York University, 2000): 2.  
<<http://pages.stern.nyu.edu/~igiddy/ABS/absasia.pdf>> (accessed December, 2004).

<sup>21</sup> *ibid*

homogenous pool of assets with predictable cash flows might consider establishing a special purpose entity to which to sell the assets through a program funded by the sale of securities. Second, securitization allows, in fact requires, traditional banking functions, such as loan origination, credit guarantee or enhancement, loan monitoring and servicing, and funding, to be unbundled and, when appropriate, contracted to specialized agencies. Thus, securitized finance competes with bank finance on at least two levels. It does not, however, obviate the need for banking services. To examine this competitive issue more closely, consider a bank's informational advantage vis-à-vis individual clients. In providing services consistent with securitized finance--asset origination, credit enhancement, asset servicing, lending--banks, through their lending agreements, enjoy access to proprietary information about their clients that would, in effect, allow banks a key informational role, especially in the securitization of their own assets. Thus, Chinese banks would continue to originate new loans and, to the extent these are securitized, would be positioned to offer servicing, liquidity, and credit enhancement services to the funding entity. The significance of the Chinese bank's continuing relationship to the underlying assets through credit enhancement then becomes important in an informational sense. In a typical ABS transaction that securitizes assets originated by a bank, the assets are sold to a special purpose entity without recourse. At the point of the sale, the bank's responsibility with respect to the assets theoretically ends. Insuring the bank's continued participation in the oversight of the assets creates a bond between the bank and the transaction that mitigates possible conflicts of interest that might result from the bank's superior knowledge of the quality of the assets<sup>22</sup>. Thus any credit enhancement of the originating bank would insure that it would conduct a credit evaluation of the proposed transaction, as well as actively monitor the underlying assets throughout the term of the deal. Credit enhancement techniques can take several forms depending on the nature of the transaction.<sup>23</sup> Inherent in credit enhancement services provided by banks is the presumption that if a bank has capital at

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<sup>22</sup> Arnoud W. A. Boot, "Relationship Banking: What Do We Know?" *Journal of Financial Intermediation* 9 (2000), pg12

<sup>23</sup> George S. Oldfield, "The Economics of Structured Finance," *The Journal of Fixed Income* 7(2) (September 1997),pg.95.

risk, then it is properly motivated to insure the integrity and ongoing viability of the transaction. This would be the case whether or not the credit enhancer was also the originating bank. An extension of this reasoning is that originating banks so bonded will also be motivated to write loans to quality borrowers from the outset. This is critical in that it suggests that securitization--specifically origination and credit enhancement--encourages prudential lending by forcing financial institutions to satisfy ABS market standards for loan quality and the pricing of risk.<sup>24</sup> Lastly, even if Chinese banks did not originate the assets of a transaction, they might still leverage their own quality and creditworthiness by offering credit enhancement services. These would be especially valuable in an emerging ABS market such as China. Then to the central point to take note that as banks complement public debt markets generally, so too do they provide specific informational benefits to markets for securitized assets. Certainly, the development of ABS markets may undermine certain functions of China's commercial banks. Still, they would also offer the banks considerable flexibility in asset and liability management and result in a division of labor that would permit the banks to perform value-added, fee-based services in a manner consistent with their informational advantage and broader relationship with individual clients. This informational role, however, is rooted in the quality, financial soundness, and reputational integrity of China's banks.

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<sup>24</sup> Ian H. Giddy, "Financial Institution Risk Management: The Impact of Securitization," summary of Seminar on Risk Management in Financial Institutions, Sogang University, Seoul, Korea October 2001

## Chapter-4

# TOWARD THE DEVELOPMENT OF AN ABS MARKET IN CHINA

Today, individual local markets vary widely in their support for securitized transactions and, consequently, in the volume of transactions sourced. However, many countries, including Japan and South Korea, share prominently with China a critical link to corporate restructuring. Ian Giddy offers a useful ordering of this linkage from a market development perspective. Once in recovery (i.e. active restructuring of both banks and corporations), an economy may leverage a nascent ABS market, in an early stage, as a source of funds. Thus, in recovering economies, public sector restructuring agencies may securitize the NPLs of distressed banks, usually with recourse to the originator and/or supplemented by a third party credit enhancement. In this stage, good loans may also be securitized with a third party credit enhancement. The next stage is characterized by a more broad-based securitization, as banks and corporations leverage the ABS markets for risk management, as well as funding. In the final stage, entrenched securitization, the ABS market influences pricing in other asset markets (e.g. loans and bonds), as originators structure and price assets to support ready securitization and hence liquidity.

Certainly, indigenous public markets for debt securities exist in Asia at varying levels of development. Basic legislation is also in place in many countries to support securitization. In Japan, for example, transaction volumes grew gradually, as enabling statutes emerged slowly and iteratively during the early 1990s. However, with the adoption of specific laws governing various aspects of securitization, including the establishment of special purposes companies, in 1998 and 1999, the market accelerated rapidly. The South Korean experience is similar as the volume of transactions expanded very quickly after the enactment of the Korean Act on Asset-Backed Securitization in



1998, making the South Korean market the largest in Asia.<sup>25</sup> In Taiwan, enabling legislation--Taiwan's Financial Asset Securitization Regulations--was not finalized until 2002. Accordingly, the first transaction, an NT \$3.59 billion collateralized loan obligation, originated and serviced by the Industrial Bank of Taiwan, closed in February 2003.<sup>26</sup>

Still, no Asian market is without elements of the early stages of ABS market development outlined above. In addition to diversification by the host country, transactions have also varied by currency, with substantial volumes also sourced offshore and in American dollars. Furthermore, transactions have been remarkably diverse and, in recent years, innovative with respect to securitized assets. While many early deals involved the securitization of residential and commercial mortgages, various types of loan obligations, equipment leases, auto loan receivables, and trade receivables, more recent transactions have included credit card receivables (most notably in the case of Korea), more specialized loan types, and even airline passenger tickets. Finally, and importantly in a developmental sense, many Asian deals, since the introduction of local ABS transactions, have lacked "pure" securitization structures in the sense that they frequently allow recourse to either government or private sector entities.<sup>27</sup> A case in point is the Korean Asset Management Corporation's (KAMCO) first international securitization of NPLs, which includes a feature to return loans to the originating banks should borrowers default.<sup>28</sup> In contrast to other East Asian financial systems, China, in developing a local ABS market, must proceed more fundamentally, in terms of both debt market organization and legal infrastructure. As is evident from Table 1, China's public debt markets are rudimentary. They consist of market sectors for treasury, financial institutions, and enterprise bonds, with the latter particularly circumscribed. Furthermore, they are burdened with a host of structural impediments.<sup>29</sup> For example, due to the

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<sup>25</sup> Mark B. Johnson, "Korea Leads Asia Securitization Foray," *Asiamoney*, June 2001.

<sup>26</sup> Mark B. Johnson, "Taiwan ABS Sets Landmark," *Asiamoney*, March 2003.

<sup>27</sup> Mark B. Johnson, "Korea Leads Asia Securitization Foray," *Asiamoney*, June 2001.

<sup>28</sup> Chris Wright, "KAMCO Leads Region with ABS Landmark," *Asiamoney*, September 2000

<sup>29</sup> Zhou Xiaochuan, "Explore Market Position to Promote Corporate Bond Development," speech by PBC Governor delivered at the International Seminar on Bond Market Development: Opportunities and Challenges, December 12, 2003.

current state of capital market development, there are few institutional investors in China, thus making information structures that much more important. Yet these credit rating, accounting, and audit services remain weak and therefore undermine the credibility of information disclosure. With specific reference to credit ratings, local agencies lack reputational value, while overseas agencies frequently constrain local corporate ratings in order to remain below central government levels. Pricing mechanisms are underdeveloped, and as a result, risk is not effectively incorporated into bond spreads. While the basic regulatory infrastructure to issue debt securities, though constraining, is in place in China, the legal infrastructure required to support securitization has not yet been comprehensively developed. Certainly, there are examples of securitized transactions by Chinese-domiciled firms, such as the oft-cited 1997 and 1999 deals by China Ocean Shipping Company (COSCO). In both transactions, COSCO securitized future shipping revenues offshore<sup>30</sup>. However, onshore transactions remain elusive because of legal ambiguities and inherent weaknesses in China's financial and banking markets.

Legal infrastructure is a necessary precondition of the development of indigenous ABS markets. Such infrastructure supports:

- 1) the transfer or sale of assets;
- 2) the establishment of independent special purpose entities, in the form of either a company or trust, to acquire the transferred assets; and
- 3) the issuance of debt securities. In China's case, each of these presents a practical hurdle to effective securitization.

No legal restrictions exist in China on the transfer of loan rights. Transferees are required only to notify the borrower of the transfer of the loan, as opposed to gaining formal consent<sup>31</sup>. However, Chinese law does not address the notion of a "true" sale of an asset

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<sup>30</sup> Lou Jianbo, *China's Troubled Bank Loans: Workout and Prevention* (New York: Kluwer Law International, 2001).

<sup>31</sup> Melissa Thomas and Ruoying Chen, "Securitization in China: Issues and Progress," *FinanceAsia.com*, July 21, 2003, <<http://www.financeasia.com>> (accessed January, 2005).

for purposes of securitization. It leaves uncertain the treatment of recourse and the enforcement of a transferee's rights<sup>32</sup>.

Chinese Company Law does not support the formation of special purposes companies, but instead requires that Chinese-incorporated companies function as operating businesses. Furthermore, in order to issue negotiable debt instruments, a Chinese company is required to maintain statutory levels of assets and earnings, each of which may detract from the otherwise one-dimensional operating objectives of the SPC. Finally, corporate bonds are the only sanctioned form of corporate debt security in China, the issuance of which is subject to rationed access based on regulatory approval. In spite of the forgoing constraints posed in transferring assets, establishing a SPC, and issuing securities, there is nonetheless some evidence of effective regulatory arbitrage taking place in China, which is advancing the "technology" of asset securitization. To take note in this regard, a recent transaction by Chinese Asset Management Company (AMC) Huarong and China International Trust and Investment Company (CITIC), which leverages China's Contract Law and 2001 Trust Law<sup>33</sup> to establish a single trust with CITIC as trustee. Under this arrangement, the organizers packaged together a portfolio of distressed bank assets, created beneficial interests in the trust, and then sold these interests to local investors.<sup>34</sup> Though not technically a securitization transaction, the deal is nonetheless consistent with the structure of asset-backed securities.

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<sup>32</sup> Hui (Hannah) Cao, "Asset Securitization: Is It a Resolution Option for China's Non-Performing Loans," Brooklyn Journal of International Law 28 (2003)

<sup>33</sup> Cao, "Asset Securitization," and Rob Davies, "Interest in Securitization Growing in China," FinanceAsia.com, August 14, 2003, <[http:// www.financeasia.com](http://www.financeasia.com)> (accessed December, 2004).

<sup>34</sup> Davies, "Interest in Securitization Growing in China" and Owen Brown, "China's Huarong and CITIC to Securitize Loans," Wall Street Journal, June 27, 2003.

## Chapter-5

# CHINA'S NPLS: IMPETUS FOR OR BARRIER TO INNOVATION?

In addition to the legal and regulatory impediments that slow the development of China's ABS market, the structural weaknesses of China's banking sector pose a more difficult challenge and potentially more significant barrier to overcome; chief among these, of course, is China's problem with NPL.

The critical link between the supply of assets and the development of China's ABS markets rests primarily on the question of China's NPLs and the manner by which these distressed credits are restructured. China has followed the lead of the United States, Japan, and South Korea, among others, in using specialized companies to acquire, structure, and then retire or dispose of such assets. Established in 1999, China's four AMC's are each paired to one of the large Chinese state banks. Also, each was capitalized with initial equity from China's Ministry of Finance, with the majority of additional cash capital provided in the form of People's Bank of China lending. Acquisitions of NPLs by the AMC's from the banks have been funded primarily by securities, which, assuming implicit state guarantees of the AMC's, allow the banks to lower the risk of their asset base.

The AMC's are not intended as a permanent construct of the Chinese banking landscape; according to the statute that created them, they will be dismantled in 2009.<sup>35</sup> Consequently, the operational dichotomy created whereby Chinese banks originate but do not restructure credits will end. This is critical to encourage banks to build long-term relationships with financially sound borrowers, while providing a broad array of services, including prudential lending. It is furthermore supportive of securitization in that it

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<sup>35</sup> John P. Bonin and Yiping Huang, "Dealing with the Bad Loans of the Chinese Banks," *Journal of Asian Economics* 12 (2001): 205.

establishes banks at the center of China's ABS markets as originators, servicers, and guarantors. In the near term, however, the relationship between the AMCs and their banks can potentially impede ABS market development in China. In 1999 and 2000, original NPL transfers by the banks to the AMCs amounted to more than 20 percent of the combined loan books of the four banks, without the assumption that these represented all NPLs on the books of the banks and given the international differences in problem loan classification then occurring. Furthermore, in establishing the AMCs, the sale of additional NPLs was not precluded. As a result, the interdependence of the bank and its AMC poses the risk of moral hazard should banks assume that they can dispose of poorly performing assets through their AMCs. This has two obvious implications for China's ABS markets. First, if not encouraging poor lending decisions, it might nonetheless relieve pressure on banks to rapidly improve the new credit process. As a result, efforts to arrive at a uniform standard of risk in corporate lending are impaired. Secondly, the "stock" problem of NPLs becomes a potentially more threatening "flow" problem should new distressed loans emerge and their volumes increase. Further complicating the potential agency issues stemming from the bank-AMC relationship is the AMCs' mandate to restructure specific credits through the use of debt-equity swaps. In analyzing the role of debt-equity swaps in corporate restructuring in China, it should be noted that the government's motivation behind the concept was rapidly to deleverage Chinese SOEs and to increase their short-term profitability by reducing financial expenses. There can be unintended consequence may be significantly less benign for the flow of NPLs: particularly the disincentive on the part of ailing SOEs to improve performance and hence their ability to service debts. If measured then by the stock and flow of distressed bank loans, China's ABS markets will be burdened by the challenge of securitizing NPLs. Several points are warranted here. First, effective securitization depends critically on a portfolio of assets diversified by borrower, but nonetheless homogeneous with respect to asset type (including the contractual bases of the underlying assets). In the case of China, NPLs can be highly concentrated both among borrowers and by sector (i.e. SOEs are themselves concentrated in traditional industries). Second, the asset portfolios must be able to generate reliable cash flows. Certainly this is most difficult to accomplish among distressed debtors. Third, in "transition economies," the

disposition of NPLs collateralized largely by government-owned assets must be carefully controlled to avoid the leakage of state assets into private hands at undervalued prices. Finally, where recovery rates generally are important in structuring asset-backed transactions, they are particularly important in securitizing portfolios of NPLs. As a proxy for potential recovery rates on securitized NPLs in China, it is to be taken note that the recovery experience of the AMCs compiled in Table 2 as varying, based fundamentally on the lending experience of the originating state bank, but generally low.<sup>36</sup>

The burden of China's NPLs therefore poses a significant challenge to the development of local ABS markets. Most critically, the supply of China's NPLs must be brought immediately under control through concerted efforts by the banks and AMCs to address systemic issues, including those of bank-AMC governance, which may contribute to the flow of non-performing assets. However, as the experience of several of the Asian crisis economies indicates, restructuring through use of ABS markets must be one component in a wider approach to ABS market development that includes the strengthening of the financial soundness and reputational integrity of China's banks and the liberalization of alternative asset markets so as to promote, in parallel with securitizing NPL portfolios, the broad-based securitization of other assets.

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<sup>36</sup> See Annexure

## CONCLUSION

The primary objective of this project was to establish the informational role of banks as a key requirement in the development of public debt markets generally, but more specifically in the development of markets for asset-backed securities. The common thread throughout my analysis has been the importance of financially sound, reputationally strong banks in fostering capital market development by reducing information problems and conflicts of interest between debtors and bondholders, most especially in developing financial systems, such as China's, in which information structures (e.g. credit rating agencies and financial media) remain weak or non-existent. Therefore, rather than viewing ABS market development as a panacea for the challenges that confront China's banking sector, in this project it has been tried to discover that many of the monitoring and governance problems that burden China's banks are what stand in the way of ABS market development. Thus, while ABS markets buttress the banking sector, they are themselves dependent on the commercial viability and financial soundness of the banks to enhance credits, normalize risk, standardize pricing, and insure a flow of good quality assets.

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