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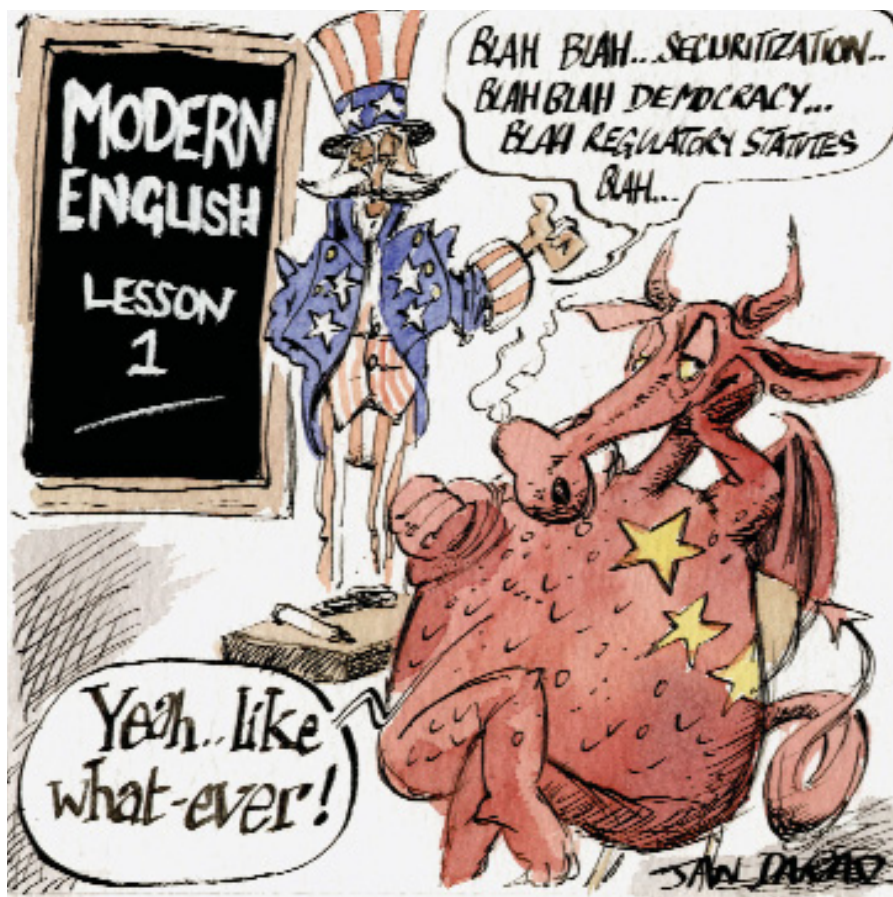
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What China can learn from US securitization

China has made a good start to creating a legal framework for securitization but some fundamental structural issues must be resolved. By Jian Wang of Cadwalader, Wickersham and Taft LLP

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China's financial system has been undergoing a fundamental transformation since the country joined the World Trade Organization (WTO) in November 2001. Under the WTO agreement, China must open its financial market to foreign competition by 2006. To strengthen its financial system and prepare for the anticipated fierce competition from foreign banks, China has taken numerous measures to bolster its banks. China is also striving to modernize its capital market and one of the initiatives is to create an asset backed securities (ABS) market. A mature ABS market would offer Chinese banks the opportunities to diversify risks, increase liquidity and raise capital more efficiently. The potential for an ABS market in China is also enormous: the financial assets owned by Chinese banks amount

to 30 trillion yuan (\$3.8 trillion) as of July 2005.

In 2003, China's State Council established a pilot program allowing two Chinese banks to issue ABS. China Construction Bank will issue 5 billion yuan (\$600 million) of securities backed by residential mortgage loans and China Development Bank will issue 10 billion yuan (\$1.2 billion) of securities backed by infrastructure loans. To provide a solid legal basis for the pilot program, China's regulatory agencies have promulgated regulations to govern ABS issuance. On April 20, 2005, the People's Bank of China (PBOC) and China Banking Regulatory Commission (CBRC) issued the Administrative Rules for Pilot Securitization of Credit Assets (the ABS Administrative Regulation). On June 13, 2005, PBOC promulgated the Rules for

the Information Disclosure of Asset-Backed Securities (the ABS Disclosure Regulation, together with the ABS Administrative Regulation - the ABS Regulation).

Comparative analysis between Chinese laws and US laws

The ABS Regulation is not only a tentative legal framework with a focus to facilitate the pilot program but also a promising starting point for future legislation for asset securitization in China. However, to expand the scope of the Regulation and establish a mature legal framework, some fundamental issues remain to be addressed. Specifically, any future legislation will need to address the issues of special purpose vehicles, substantive consolidation, true sale and regulatory agencies' role. Given that the US has the most sophisticated ABS market in the world, this article draws on the experience in the US for a comparative analysis.

Lesson one: special purpose vehicles (SPVs) should be simple to establish and operate

The fundamental concept of an asset securitization transaction is that by setting up a bankruptcy-remote SPV, certain financial assets of the originating entity will be isolated and investors will look to the isolated assets to evaluate the investment risks and returns. In the US, an SPV is typically a newly created entity in the form of a limited liability company, a business trust or a corporation under state corporate laws. US corporate laws for creating a business entity to engage in specified activities are flexible. As long as minimum formalities are observed, there are no restrictions on capital structure or ability to issue debts. For example, under the Delaware Limited Liability Company Act, a limited liability company can be established by simply filing a certificate of formation. The only information required in the certificate of formation is the name of the entity, the address of the registered office and the name and address of the registered agent. Typically, an operating agreement will be executed subsequent to the filing of the certificate of formation. The operating agreement will set forth provisions governing management, capital contribution and membership interests. A typical operating agreement for a SPV will have limited purpose provisions, no petition provisions, separateness provisions and negative covenants.

In comparison, Chinese laws impose significant legal impediments on estab-

The ABS Regulation

The scope of China's ABS Regulation is limited to transactions where a bank is the originator of the collateral. The Regulation incorporates fundamental securitization concepts such as special purpose vehicles, bankruptcy remoteness, disclosure and credit ratings. The most important thing the ABS Regulation does is to allow an originating bank to transfer financial assets to a special purpose trust and permit the trust to issue securities backed by the financial assets.

The Regulation guarantees the bankruptcy remote status of the special purpose trust by providing that in the case of the originator or the trust's bankruptcy, liquidation or reorganization, the trust assets are not properties of the bankruptcy estate. The legal relationship between the originating bank and the special purpose trust would be governed by a trust agreement that would specify the rights and obligations of parties, servicing and

management of the assets, asset portfolio and termination events. A servicer would be appointed under a servicing agreement whereby the servicer manages the assets.

The ABS Disclosure Regulation requires the truthful and accurate disclosure of information to investors. An issuer must disclose to investors the issuance charter, the credit ratings, the prospectus and the names of the underwriters five business days before any issuance. In the offering materials, the issuer must disclose the investment risks of the securities. In the event of the occurrence of a negative event such as the downgrading of credit ratings of the securities, the issuer must disclose this information to the regulatory agencies within three business days of the occurrence of such an event.

The ABS Regulation specifically carves out accounting and tax rules and leaves them for future regulation.

lishing a separate and independent SPV. Under Chinese company law, issuing corporate bonds requires that the net assets of a limited liability company be at least 60 million yuan (\$7.8 million), while the cumulative value of company bonds must not exceed 40% of the company's net assets. No additional corporate bonds can be issued when the previously issued bonds have not been fully subscribed. Chinese trust law and related regulations are similarly restrictive for issuing debt securities. A trust

and investment company is not allowed to issue bonds or certificates, borrow from abroad or promote marketing through newspaper, TV or radio. The total amount of outstanding borrowing must not exceed an SPV's registered

capital. These restrictions for issuing corporate bonds under Chinese law render the establishment of an SPV prohibitively expensive.

Under the ABS Regulation, the People's Bank of China has carved out a safe harbour and authorizes the establishment of a special purpose trust for the specific purpose of facilitating an asset securitization under the pilot program. But the restrictions on issuing debt securities under Chinese laws remain in effect. To establish a comprehensive legal

framework for asset securitization, Chinese laws should be more liberal and flexible for corporate entities to create a SPV and issue debt securities.

Lesson two: Chinese bankruptcy law should set forth criteria for a substantive consolidation analysis

To adequately isolate assets transferred from an originator to an SPV, the structure of an asset securitization transaction must minimize the risk of a substantive consolidation in event of the originator's bankruptcy. The concept of substantive consolidation refers to a bankruptcy court's power to consolidate ostensibly separate but relat-

ed entities and treat the assets and liabilities of the entities as if they belong to a single entity. The bankruptcy remote status of an SPV is critical to the overall structure of an asset securitization transaction. The debt securities issued by the SPV can achieve a higher credit rating than the originator only if the SPV is insulated from the originator's bankruptcy risk. Without the bankruptcy remoteness, the entire structure will be vulnerable to a substantive consolidation attack in the event of the originator's bankruptcy.

In the US, there is an established body of case law setting out criteria for the issue of substantive consolidation. These factors include:

- the degree of difficulty in segregating and ascertaining individual assets and liabilities;
- the presence or absence of consolidated financial statements;
- the profitability of consolidation at a single physical location;
- the commingling of assets and business functions;
- the unity of interests and ownership between the various corporate entities;
- the existence of parent and intercorporate guarantees on loans; and
- the transfer of assets without formal observance of corporate formalities.

In a typical asset securitization transaction under the US laws, a legal opinion from an independent legal counsel is provided stating that if the originator becomes bankrupt, the SPV will not be substantively consolidated with the originator.

Chinese bankruptcy law does not at present provide any guidance on substantive consolidation. The ABS Regulation ensures bankruptcy remoteness by providing that the assets transferred to the special purpose trust will not be part of bankruptcy estate in the event of the originator's bankruptcy. But the fundamental issue of what triggers a substantive consolidation remains unresolved. Without clear guidance on substantive consolidation, a securitization would not gain market confidence and a single failure would cause catastrophic consequences for the entire ABS market in China. Therefore, it is paramount for Chinese bankruptcy law to set forth criteria for a substantive consolidation analysis. Codifying the criteria for substantive consolidation would boost market confidence and reduce uncertainties associated with an originator's bankruptcy risk.

Lesson three: whether a transfer is a true sale or secured loan should be clarified

The transfer from the originator to the SPV should be a so-called true sale. A true sale means a transfer of assets where the transferor no longer has any legal or equitable interest in the assets. It is necessary to distinguish a true sale from a secured loan. If the transfer from the originator to the SPV is characterized as a secured loan, the originator will retain its ownership interest in the assets and the SPV will only have a

The bankruptcy-remote status of an SPV is critical to the overall structuring of an asset securitization transaction

security interest in the assets, causing the assets to be subject to an automatic stay in the event of the originator's bankruptcy. Under US laws, whether a transaction is a true sale or a secured loan is determined by balancing various factors. The factors include: the intent of the parties; the amount of recourse to the originator for credit or market value risks; the right or obligation of the originator to repurchase the assets; and the amount of control the originator retains over the assets.

Under China's ABS Regulation, the originator transfers assets to a special purpose trust under a trust agreement. The relationship between the issuer and the originator appears to be a trust relationship where the originator still retains the equitable interests and the issuer holds the legal title of the collateral. The implication of such a structure is the dilution of collateral value because of the originator's bankruptcy risk. For the purpose of the pilot program, this might not be a significant issue because the originating banks usually have good credit ratings and little chance of going bankrupt. In addition, the ABS Regulation limits the special purpose trust's exposure to the originator's bankruptcy risk. However, for potential ABS issuance by other compa-

nies with lesser credit ratings, it is critical to clarify the legal and equitable interest in the collateral, and the legal relationship between an originating entity and an issuing entity.

Lesson four: regulatory involvement should focus on disclosures

Under the ABS Regulation, China's regulatory agencies play a significant role in an asset securitization transaction. A special purpose trust must deliver to PBOC an application, the trust agreement, the underwriting agreement, legal opinions and rating agency confirmation. When the trustee is terminated, CBRC is in

charge of appointing an interim trustee before a successor trustee is appointed. Within 10 business days of any ABS issuance, the issuing trust must report to PBOC and CBRC on the status of the issuance. Any decisions rendered in an investor meeting must be reported to PBOC.

Given the ABS Regulation's focus on the pilot program and the absence of a mature capital market, the involvement of regulatory agencies is appropriate. China's current capital market does not have the sophistication to adequately discipline an asset securitization transaction.

But with China's capital market becoming more mature, extensive regulatory agency involvement will create unnecessary transaction costs and impede the development of China's ABS market. The regulatory agency should focus on disclosure issues and provide confidence for the market about the integrity of any information being distributed in an asset securitization transaction.

The business aspects of the transaction, such as the facility documents, underwriting arrangement and corporate governance of the issuer, should be properly left to the rating agencies, issuers, underwriters, law firms and other transaction participants.

China's ABS Regulation is a promising start for a comprehensive legal framework for asset securitization. However, several fundamental issues must be addressed. Chinese corporate laws must be more liberal and flexible for establishing an SPV and issuing corporate debt securities. China's bankruptcy law should articulate the criteria for a substantive consolidation analysis and the legal and equitable interests in the collateral need to be further clarified.

With China's capital markets becoming more mature, the regulatory agencies should now focus on regulating disclosures and leave the business aspects and structuring of ABS transactions to market discipline. ■

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