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Consumer Finance & Non-Banking Financial Institutions Working Group

November 13, 2012

Regulatory Framework on Pilot Projects of Credit Assets Securitization in China

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Introduction

- Administrative Measures on Pilot Projects of Credit Assets Securitisation (the "**Securitization Measures**")
- Promulgated by both the People's Bank of China ("**PBOC**") and the China Banking Regulatory Commission ("**CBRC**"), both departments of the State Council
- Date of promulgation: April 20, 2005
- Effective date: April 20, 2005

Introduction

- Notice on Further Expansion of Credit Asset Securitization Pilot Program (“Notice No. 127”)
- Promulgated by PBOC, CBRC and Ministry of Finance
- Promulgated: 05/17/2012
- Effective: 05/17/2012
- This Notice prevails over previous credit asset securitization provisions in case of any discrepancies.

Definition of Securitisation - Scope of the Securitisation Measures

- Art. 2: *“The measures apply to structural financing activities within China in which bank institutions, as the originators, entrust credit assets to trustees, and the trustees issue beneficiary securities in the form of asset-backed securities to investing institutions, and pay the proceeds of asset-backed securities with cash generated from such assets.”*
- Scope of the Securitisation Measures:
 - ↳ Domestic transactions only
 - ↳ Cash securitization only (vs. synthetic securitization **forbidden**)
 - ↳ State Council-approved pilot projects only (“**Securitization Measures**”)
 - Pilot projects approved according to the Securitization Measures:
 - ↳ China Construction Bank (mortgage loans), date of approval: March 21, 2005
 - ↳ China Development Bank (infrastructure loans), date of approval: March 21, 2005
 - Pilot projects approved according to Notice No. 127
 - ↳ China Communication Bank (Credit assets), date of approval: October 15, 2012
- Upcoming pilot projects – maybe, likely to be projects backed by other types of credit assets

Definition of Securitisation - Scope of the Securitisation Measures

- Bank originators only (Notice No. 127 has same principles as Securitization Measures)
 - ↳ Chinese bank institutions
 - ↳ Foreign invested bank institutions and Chinese branches of foreign banks provided that they have a RMB license

- Credit assets only: assets requiring risk capital allocation

- Limited refinancing market: PRC's National Inter-bank Bond Market ("**NIBBM**") only

Status of the Securitisation Measures

- Formulated in accordance with, inter alia, the PRC Trust Law
- Chinese laws and higher administrative regulations prevail
- Securitization Measures to be completed by other administrative rules on, *inter alia*:
 - ↳ Accounting and tax issues
 - ↳ Changes in real property mortgage registration
 - ↳ Investment policies with regard to the purchase and possession of ABS
 - ↳ Supervision of the securitization participants

Objectives and Principles

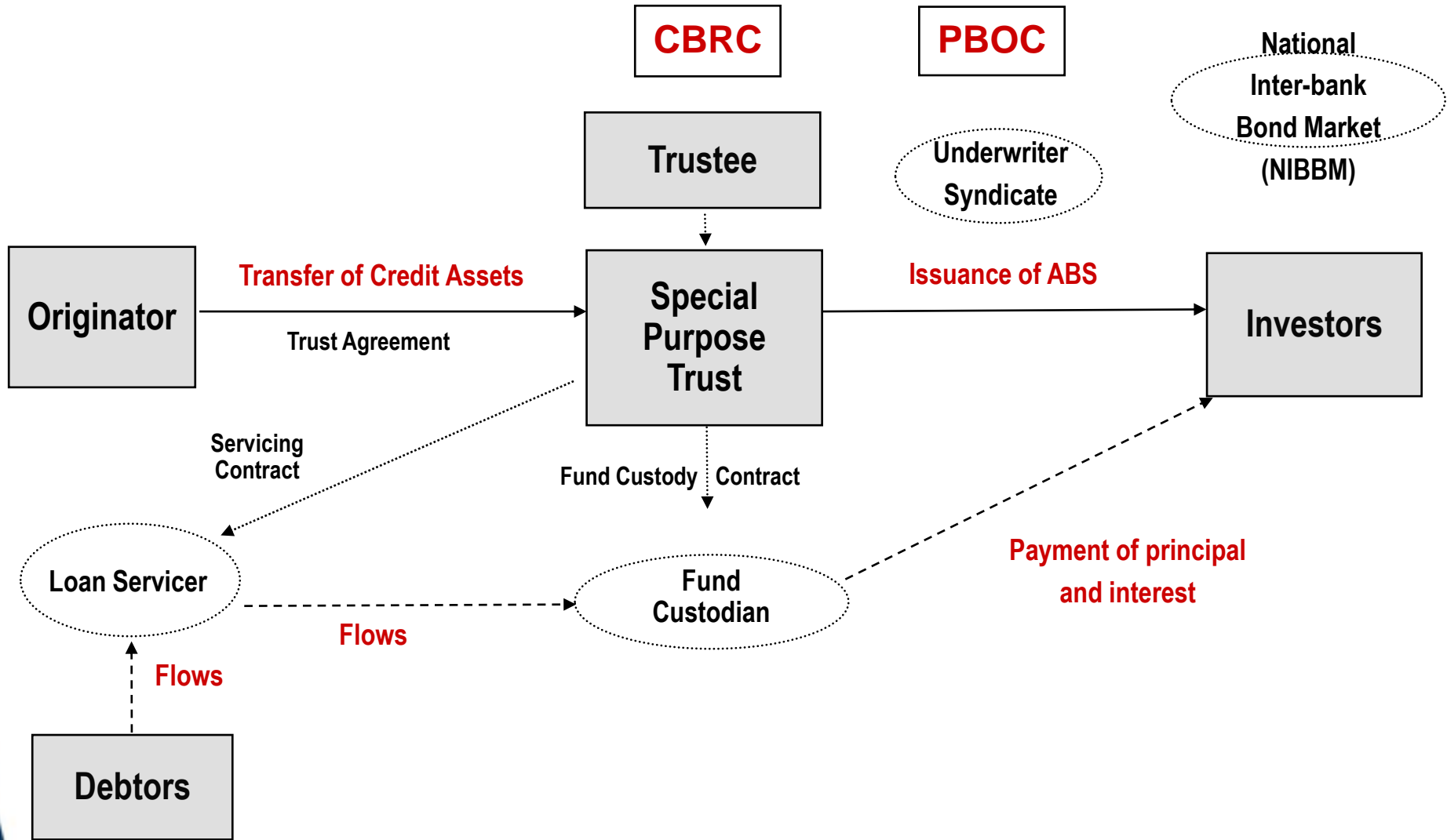
- Diversified and balanced objectives:
 - ↳ Regulating pilot projects of credit assets securitization
 - ↳ Protecting the legal rights and interests of investors and relevant parties concerned
 - ↳ **Enhancing the mobility of credit assets**
 - ↳ **Diversifying the variety of securities**
- Guiding principles:
 - ↳ Art.5: “*Credit assets securitisation activities shall be carried out in accordance with the principles of voluntariness, fairness, and good faith, and shall not impair the interests of the State or the public interest of the society”*”
 - ↳ Art.8: “*The trustees, loan servicers, fund custodians, securities registration and depository institutions and other institutions rendering services for securitisation transactions shall fully comply with their responsibilities and perform their obligations in good faith and with prudence and diligence.*”

Objectives and Principles

- Great freedom to contract - terms and conditions set forth in the contract:
 - ↳ Trust agreement
 - ↳ Loan servicing contract
 - ↳ Fund custody contract
 - ↳ Placement / underwriting agreement
 - ↳ Draft agreements are however subject to PBOC approval

- Public supervision:
 - ↳ CBRC: supervision of the business activities of the several participants
 - ↳ PBOC: supervision of the issuance and trading of ABS on the NIBBM

Securitisation Scheme



New Requirements Imposed by Notice No. 127

■ Risk retention

- ↳ An originator of a credit asset securitization scheme must hold a certain percentage of the lowest tranche of the asset-backed securities in the scheme
- ↳ At least 5% of all asset-backed securities issued for the scheme
- ↳ For a period of at least the term of the securities of the lowest tranche
- ↳ This restriction has no retroactive effect.

New Requirements Imposed by Notice No. 127

■ Credit ratings

- ↳ An originator must have 2 qualified credit rating agencies make initial and ongoing credit ratings for the issuance and trading of its asset-backed securities on the national interbank bond market
- ↳ Submit the ratings reports of the credit rating agencies to financial regulators to apply for the issuance
- ↳ Exploring and adopting diversified credit ratings is encouraged
- ↳ Credit rating agencies should strive to enhance the **transparency and credibility** of credit ratings of asset-backed securities

Investor Requirements

- Expansion of the scope of institutional investors for asset-backed securities
- Encourage **insurance companies**, *securities investment funds, enterprise annuities, the National Social Security Fund and other approved and compliant non-banking institutional investors* to invest in asset-backed securities
- In principle, a single banking financial institution buy and hold not more than 40% of the total number of asset-backed securities issued for a single asset-backed securities product

Eligible Assets

- Credit Assets: assets recorded on the originator's balance sheet as credit assets which require risk capital allocation
 - ↳ Loans
 - Residential mortgage loans
 - Commercial mortgage loans
 - Acquisition loans
 - Consumer loans
 - Automotive loans
 - Public loans
 - Inter-bank loans
 - Infrastructure and project loans
 - ↳ Receivables: factoring receivables, credit card receivables, etc.
 - ↳ Bonds and securities: unlikely as most of the originators invest in Chinese State Treasury bonds or bonds issued by policy banks which are already having a high mobility
 - ↳ Performing and non performing credit assets
 - ↳ RMB denominated credit assets since issued ABS shall be denominated in RMB

Transfer of Credit Assets

- By way of establishing a special purpose trust ("**SPT**")
- Trust agreement, including *inter alia*:
 - ↳ Scope, type, criteria and status of the trust assets
 - ↳ Identification of beneficiaries and means by which they obtain their trust benefits
 - ↳ Trust term
 - ↳ Rights and obligations of the originator and the trustee
 - ↳ Organization and powers of the ABS holders' meetings
 - ↳ Events leading to termination of the SPT

Transfer of Credit Assets

True sale ?

- Uncertainties as to whether or not the entrustment of property right by the originator to the trustee constitutes a transfer of ownership (“**True Sale**“)
- Enforceability of the transfer towards right holders (debtors and third parties), conditional upon the making by the originator of a public announcement on **national media**
 - ↳ Uncertainties as to the effect of such public announcement since PRC Contract Law requires the notification of the debtor, although a 2001 Supreme People Court's judicial interpretation on the transfer of NPLs to assets management companies recognizes that making a public announcement is deemed to fulfill the PRC Contract Law notification requirement
 - ↳ Supreme People Court's judicial interpretation expected as regards transfers of credit assets to SPT under securitization pilot projects
 - ↳ Notification advised meanwhile with respect to making the transfer enforceable towards debtors, even if it may raise practical issues

Transfer of Credit Assets

True sale ?

- Isolation of the securitised credit assets
 - ↳ Provisions of the PRC Trust Law (Article 15 & Article 16)
 - ↳ Securitisation Measures (Article 6)
 - Trust assets are independent from the assets owned by the originator, the trustee, the loan servicer, the fund custodian, the securities registration and depositary institutions
 - In the event of the liquidation resulting from their dissolution, revocation or bankruptcy under law, the trust assets shall not be included in their liquidated property

Transfer of Credit Assets

Off balance sheet treatment?

- Accounting and prudential administrative regulations to be promulgated later
- Off-balance sheet treatment under IFRS 39 and SIC 12 requires:
 - ↳ Transfer of the risks and rewards (IFRS 39)
 - ↳ Absence of control over the SPT (SIC 12)
 - ↳ Credit risk transfer
 - No guarantees or subordinated loans extended by the originator or its affiliates
 - No subscription of subordinated ABS or residual piece
 - No buy-back option unless at fair market value and under limited circumstances
 - Calculation of discount on each generation of credit assets (not on a retroactive basis)
 - ↳ Continuing involvement
 - Transfer of collection on a timely basis
 - Loan servicer remunerated at market conditions
 - Right of the trustee to terminate the loan servicer's duties and to appoint a substitute loan servicer

Transfer of Credit Assets

- No automatic transfer of security interests, unless the carrying out of usual formalities:
 - ↳ Current transfer of mortgages:
 - Registration fees of RMB 100 (about USD 10)
 - New registration will be processed within 7 business days (Shanghai practice)
 - ↳ Upcoming administrative rules on changes in real property mortgage registration: easier formalities expected

- Non-transferability clauses in the underlying contracts may, in accordance with the PRC Contract Law, result in the transfer of relevant credit assets being null and void

Transfer of Credit Assets

- Assignment on a rollover basis implicitly allowed since issuance of ABS in several instalments permitted, though subject to a capped amount
- Redemption or replacement of non conforming credit assets in case of a breach of conformity warranties:
 - ↳ Will not affect the off balance sheet treatment
 - ↳ No ongoing representations and warranties regarding the credit quality of the securitised credit assets
- Buy-back clause allowed: off balance treatment, provided that transfer back is made at market conditions and in limited cases: misrepresentation, non recoverable assets, at liquidation (clean-up call)

Securitization Vehicle and Other Participants

- SPT set up in accordance with the PRC Trust Law
- Management of the SPT by a trustee
- Bankruptcy remoteness of the SPT
- Master trust with several compartments: ring fencing of the compartments
- Other main participants:
 - ↳ Loan servicer
 - ↳ Fund custodian

Securitization Vehicle and Other Participants

■ Trustee:

- ↳ Management of the trust assets (credit assets and proceeds)
- ↳ Issuance of the ABS
- ↳ Disclosure of information on a continual basis and verification of reporting (prior information to the National Interbank Lending Centre and the China Government Securities Depository Trust & Clearing Co., Ltd)
- ↳ Issuance of an annual report audited by a certified public accountant
- ↳ Distribution of trust benefits to ABS holders

Securitization Vehicle and Other Participants

- Main duties:
 - ↳ Duly established trust and investment company
 - ↳ Any other institutions approved by the CBRC
 - ↳ Appointed pursuant to the trust agreement
 - ↳ Non bank institution
 - ↳ Licensed by the CBRC
 - ↳ There are currently about several hundreds trust and investment companies, such as the China International Trust and Investment Company (CITIC)

Securitization Vehicle and Other Participants

- Prohibition of set-off between claims arising from the operation and disposal of the trust assets by the trustee and liabilities arising from the assets owned by the securitisation participants
- Termination of the trustee's duties:
 - ↳ Dismissal by ABS holders meeting (according to the trust agreement)
 - ↳ Dissolution, revocation or bankruptcy (temporary trustee appointed by the CBRC)
 - ↳ Revocation by law (temporary trustee appointed by the CBRC)

Securitization Vehicle and Other Participants

■ Loan servicer:

- ↳ Appointed by the trustee for the management of loans, pursuant to a servicing contract and in accordance with the trust agreement
- ↳ Professionally qualified institution to service loans:
 - **Can be the originator**
 - If not, notification of the debtors of the new collection account bank's details or will the public announcement on national media be sufficient ?
- ↳ Main duties:
 - Collecting principal and interest of the credit assets
 - Managing the credit assets
 - Keeping independent legal documents concerning the trust assets
 - Providing the trustee with periodical servicing reporting

Securitization Vehicle and Other Participants

- ↳ Obligation to establish a specialized business department to keep separate accounts for, as well as manage in a separate manner, the credit assets placed under the trust
- ↳ Obligation to transfer the funds collected from the credit assets to the fund custodian and to inform the trustee of the same
- ↳ Absence of commingling risk: funds collected by the loan servicer are not part of the loan servicer's assets and cannot be attracted by its creditors
- ↳ Termination of the loan servicer's duties:
 - By the trustee
 - In case of breach of the servicing criteria set forth in the servicing contract
 - Prior decision of the ABS holders meeting required
 - Obligation to inform the obligors in a timely manner
- ↳ Back-up servicing: not specified but should be contractually possible

Securitization Vehicle and Other Participants

■ Fund custodian:

- ↳ Appointed by the trustee for the management of funds standing to the credit of trust banking accounts, pursuant to a fund custody contract
- ↳ Commercial bank or other professional institution
- ↳ **Neither the originator nor the loan servicer**
- ↳ Main duties:
 - Custody of the funds collected from the trust assets in a safe manner
 - Opening an account for the funds collected from the trust assets in the name of the SPT
 - Paying investment proceeds to the ABS holders in the manner agreed upon in the fund custody contract
 - Managing the funds in the SPT's account in the manner agreed upon in the fund custody contract and as instructed by the trustee
 - Providing the trustee with periodical fund custody reports

Securitization Vehicle and Other Participants

- ↳ Possibility for the trustee to entrust certain obligations to other servicing entities (commercial banks or other professional institutions):
 - Payment of the investment proceeds to the ABS holders
 - Management of the funds in the SPT's account
 - Providing periodical fund custody reports

- ↳ Termination of the fund custodian's duties:
 - By the trustee
 - In case of breach of the criteria set forth in the fund custody contract
 - Prior decision of the ABS holders meeting required

Issuance of ABS

- ABS represent trust benefit shares, issued by the trustee, the payment of which is limited to the cash flows generated by the trust assets:
 - ↳ Undivided interest in a pool of assets
 - ↳ Pass through / pay through structures
 - ↳ Limited recourse to cash flows generated by the trust assets
- ABS shall be denominated in RMB
- Flexibility with regard to the maturity of ABS
- Issuance of ABS is subject to the approval of PBOC
- Possibility of issuing ABS in several instalments within a required time period but new filing required by the trustee 5 working days prior to the issuance of each instalment

Issuance of ABS

- Investors shall be members of the NIBBM:
 - ↳ Mainly bank institutions, financial institutions, financial companies
 - ↳ Uncertainties with regard to insurance companies, funds and Chinese branches of foreign banks
 - ↳ Impact of the upcoming investment administrative rules on the purchase and possession of ABS

- Conditions for the negotiation of ABS on the NIBBM which shall be borne in mind at the time of issuance:
 - ↳ One investor shall not hold more than 40% of the total amount of the ABS issuance
 - ↳ Minimum issuance amount: RMB 500,000,000 (about USD 50,000,000)

Credit Enhancement

- Credit enhancement is only mentioned by the Securitisation Measures
- Internal credit enhancement
 - ↳ Excess spread (put aside in a reserve account)
 - ↳ Over-collateralisation
 - ↳ Cash reserve
 - ↳ Security interests associated with the trust assets (mortgages, guarantees, etc.):
 - Nothing specified in the Securitisation Measures
 - Usual formalities to be carried out
- External credit enhancement
 - ↳ Issuance of senior / subordinated ABS
 - ↳ Guarantees from third parties (credit institutions, insurance companies, the originator or its affiliate companies)
 - ↳ Subordinated loans from third parties (credit institutions, the originator or its affiliate companies)

Issuance Procedure

- Submission by the trustee to the PBOC of the following documents:
 - ↳ Application form
 - ↳ Drafts of the trust agreement, loan servicing contract, fund custody contract and other relevant legal documents
 - ↳ Draft of the prospectus
 - ↳ Placement / underwriting agreement
 - ↳ Legal opinion by a licensed lawyer
 - ↳ Accounting opinion by a certified public accountant
 - ↳ Draft of a credit rating report by a credit rating institution and the ways in which the rating will be followed up
 - ↳ Other documents required by the PBOC

Issuance Procedure

- CBRC decision on whether or not the application is acceptable within 5 working days following the receipt of the documents:
 - ↳ In case of application refusal, reasons for refusal shall be given in writing by the CBRC to the applicants
 - ↳ In case of application acceptance, written decision of issuance approval or disapproval shall be made by the CBRC within 20 working days following the date of the application acceptance

Issuance Procedure

- Release by the trustee of the final prospectus 5 working days before the issuance
- Issuance of the ABS on the NIBBM
- Reporting to the CBRC and the PBOC within 10 working days following the completion of issuance
- Application for the trading of ABS on the NIBBM:
 - ↳ Within two months following the completion of issuance
 - ↳ Made by the trustee
 - ↳ Compliance with the *Rules on Examining and Approving the Trading and Negotiation of Bonds on the National Inter-bank Bond Market*
 - ↳ Uncertainties as to the status of the issued ABS when trading application is refused / not made
- Registration, entrustment, trade and settlement of ABS on the NIBBM shall be conducted according to the *Administrative Measures on the Negotiation of Bonds on the National Inter-bank Bond Market*

Placement / Underwriting

- Placement / underwriting syndicate established by the trustee
- Placement / underwriting required regardless of the amount of the ABS issuance
- Eligible institutions:
 - ↳ Financial organisations (Chinese entities which are members of the NIBBM)
 - ↳ Registered capital of no less than RMB 200,000,000 (about USD 20,000,000)
 - ↳ Having relatively strong capabilities for placing / underwriting bonds
 - ↳ Having a team of high profile professionals in selling debt securities
 - ↳ Other conditions required by the PBOC

Placement / Underwriting

- Means:
 - ↳ Placement on an agency basis against commission
 - ↳ Purchase of all ABS with right to sub-place
 - ↳ Purchase of unplaced ABS only
- On a agreement or bidding basis
- Placement / underwriting agreement submitted to the PBOC
- Placement of the ABS during the issuing period

Credit Rating

- Rating to be assigned during the entire life of ABS in case of negotiation on the NIBBM
- No rating required if issuance made to identified investors (private placement)
- Credit rating institutions with rating qualifications:
 - ↳ Foreign rating agencies permitted
 - ↳ Possible preference of the NIBBM participants for Chinese rating agencies (e.g. China Chengxin International Credit Rating Company, Dagong Global Credit Rating Co., Ltd., Shanghai Far East Credit-rating Co., Ltd.)
- Credit rating institutions shall ensure the objectivity and fairness of their credit rating activities
- Submission to the PBOC of the draft of the credit rating report from the credit rating institution and of the ways in which the rating will be followed up

ABS Holders' Rights and Obligations

- Enjoy the benefits of the trust assets and bear risks in accordance with relevant legal documents, and make decisions on significant matters which may affect their interests through the ABS holders' meetings

- ABS holders' meetings :
 - ↳ On-site and telecommunications meetings allowed
 - ↳ Meetings convened by the trustee or, if not, by the ABS holders in accordance with the trust agreement
 - ↳ 30-day prior public notification required
 - ↳ Reporting of the ABS holders' decisions to the PBOC and release to the public

ABS Holders' Rights and Obligations

■ Rights of the ABS holders:

- ↳ Sharing the trust benefits / recourse limited to the trust assets - no recourse against or liabilities of any participants in the securitisation transaction
- ↳ Taking part in the distribution of the remaining trust assets after liquidation
- ↳ Assigning the ABS in their possession according to law
- ↳ Convening ABS holders' meetings in accordance with relevant rules
- ↳ Exercising voting rights over the issues under discussion at ABS holders' meetings
- ↳ Consulting or copying publicly disclosed documents on the trust assets and ABS
- ↳ Other rights specified in the trust agreement and prospectus

End

Thanks !



GLR

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