

China Special Report

Outlook for Securitisation in China

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Amended

This report, originally published on 31 October 2008, is being republished to correct the note issuance amount between 2005 and 2008 on page 1 and to update commentary from the *Investors: Capital Structure and Liquidity* section on page 5 onwards.

Summary

There is great demand for securitisation in China both from issuers and investors in the capital markets. The securitisation market has developed steadily over the past three years, yet the pace of development has been slower than expected.

While the administrative measures for securitisation published by the People's Bank of China (PBOC) in 2005 have formed the basic legal framework for securitisation transactions, many challenges and opportunities have surfaced during the period of progress since then.

The challenges/opportunities for securitisation apply to regulators, originators, investors and the wider international markets. This has contributed to a complicated outlook for the future development of securitisation in China.

In Fitch Ratings' opinion, key challenges and opportunities include the following:

- The global financial crisis caused by the subprime turmoil in the US has delayed the development of the securitisation market in China.
- Coordination among different government bodies affects the path and process to further develop the securitisation market in China.
- Securitisation backed by corporate assets (corporate ABS, which covers what was previously known as the Specific Asset Management Plan (SAMP)) may not surface in the near future.

Fitch is cautiously optimistic about the development of the securitisation market in China in the near future.

Current Situation

Between 2005 (when China's first pilot securitisation was issued) and October 2008, a total of RMB62bn of securitisation notes and RMB26.3bn of notes under the SAMP had been issued.

While the SAMP was suspended by the China Securities Regulatory Commission (CSRC) in 2006, a second batch of pilot securitisations worth RMB51bn has been launched in the past two years.

The underlying assets for this second batch of securitisations have been expanded to include non-performing loans (NPLs) and auto loans, while credit card receivables and small- and medium-sized enterprise (SME) loans are also expected. In addition, non-bank financial institutions such as finance companies and asset management companies have obtained approval to originate securitisation transactions.

While the regulators were planning to open the securitisation market, the subprime turmoil in the US and the subsequent global financial crisis erupted. With China's strict regulation of the financial system, it is unlikely that a similar event will happen in the country. However, as the regulators are more cautious now, the global financial crisis will hinder steps the regulators planned to loosen risk control and fully open the securitisation market.

The Role of Securitisation in China's Bond Market

China's bond market has developed rapidly in recent years, with RMB14.5trn of bonds outstanding by September 2008. Most issuers in the bond market are government agencies or banks, which normally have high credit ratings. Corporations, meanwhile, typically still rely heavily on bank loans for funding. The total volume of bank loans reached RMB23.9trn by September 2008.

As a result, the credit spectrum of the bond market is very narrow and concentrated at the high rating end, while most of the credit risk of corporations remains within the banking system.

To address this situation, a policy by the State Council (Guofa(2004) No. 3) "to push forward the reform and stability of the capital markets" states that to: "strengthen the exploration of low-risk fixed-income products, replace bank deposits with diversified securities products and actively develop securitisation products" are essential measures to develop China's capital markets.

Against such a backdrop, securitisation has been positioned by regulators to (i) satisfy diversified funding and the risk management needs of different institutions, (ii) to broaden the investment channels for investors and (iii) to release certain credit risk from the banking system.

While, in practice, large Chinese banks have more than sufficient cash at hand and they do not rely on securitisation for funding, neither can they (fully) achieve the objective to shed credit risk as they usually retain the subordinate class in a securitisation transaction.

Given this situation, the functions of securitisation in China are, in most cases, to manage the mismatch between short-term liabilities and long-term assets of banks and to acquire funding for some non-bank financial institutions.

Not surprisingly, securitisation accounts for a very small portion of the bond market in China due to its short history and some institutional issues, which will be covered later in this report.

On the corporate side, the SAMP is still suspended. Related issues will be covered in a subsequent report.

The Second Wave of Pilot Securitisations

Although there have been some innovations in the second batch of securitisations, including deal types and transaction structure, most transactions completed remain balance-sheet collateralised loan obligations (CLOs).

A balance-sheet CLO has a simple legal structure and is a practical option for banks to release some lending quotas for certain business sectors. For example, a bank has an RMB10bn upper limit for lending to the real estate sector in 2008. When the bank uses up that RMB10bn quota, it can choose to securitise part of the loan portfolio, say RMB5bn, from the sector and remove it from its balance sheet. As the RMB5bn portfolio is removed, it no longer takes up the bank's lending quota. The bank can then use the securitisation proceeds for further lending to the real estate sector.

Such an arrangement would enable small- and medium-sized banks, which often have limited access to deposits in a fast-growing regional market, to raise funds to compete with larger banks.

In addition to the relatively mature CLO structures, the first asset-backed securities (ABS) transaction backed by auto loans, GMAC-SAIC 2008-1, was issued at the start of 2008. Along with the fast development of the automotive industry in China during the past several years, automotive finance companies such as GMAC-SAIC have increasingly sought additional capital to satisfy growing demand for lending to its clients, and they are keen to use securitisation tools to raise additional funds for their businesses.

The first domestic commercial mortgage-backed securitisation (CMBS) originated by China Minsheng Bank has been planned for some time, but there is still no sign of progress for this deal, as there is no rule on the registration of assignment of rental income for commercial properties. China's tightening credit policy on the property market also negatively affects the development of such a product.

Corporate ABS

In China, there are huge amounts of corporate assets that generate stable streams of cash flows, such as toll roads, power plants and water disposal systems. Since the owners of these assets are normally actively seeking low-cost funding for expansion, corporate ABS backed by such assets is thought to be the most promising sector for securitisation in China.

SAMP had targeted that market before, but it was suspended by the CSRC due to many structural issues, including the guarantee requirement.

The CSRC aimed to resume the SAMP in 2007, and it circulated a consultation paper entitled "*Guidelines of Corporate ABS*" in September 2007 within a small group of securities companies.

However, the effort seems to have failed due to a lack of supportive feedback from said companies. The associated issues include those to do with the structure, the underlying assets and the credit ratings, as well as others in tax and accounting measures for corporate originators. These issues cannot be resolved without further discussion with other related government bodies such as the Ministry of Finance (MOF) or the State Administration of Taxation (SAT).

Given the abovementioned issues and that the primary goal of the CSRC in 2008 is to develop the corporate bond market, it is unlikely that corporate ABS will draw the attention of the CSRC in the foreseeable future.

Other Innovative Products

PBOC has been leading the development of derivative products since 2004.

In 2007, it organised the establishment of the Securities Association of China (SAC). The SAC is now preparing standard documentation for derivatives, which is similar to that of the International Swaps and Derivatives Association. The documents will pave the way for further development of the domestic derivatives market.

In view of the above, some banks are considering innovative products such as credit-linked notes. Nevertheless, such products are not yet ready for introduction to the market.

Questions Raised as to Progress Made

The pilot programmes have established the basic structure for future securitisation transactions. Accounting rules and tax measures are also well established at this stage. However, the following points have been raised following early issuances.

Is it Possible for Regulators to Fully Open the Securitisation Market in the Near Future?

Since China's financial sector has a separate operational and regulatory system, multi-ministry-spanning securitisation has to go through various approval processes depending on the specific underlying assets involved. Coordination among different regulatory bodies is still a major challenge to fully open the market.

There are two separate securities markets in China: the interbank market, which is supervised by PBOC; and the stock exchange market, which is supervised by CSRC.

Asset securitisations of banks and non-bank financial institutions (together referred to as "financial institutions") are issued and traded in the interbank market; while SAMP transactions are issued and traded in the stock exchange market.

Since most institutional investors are interbank market participants, and the scale of the market has reached RMB13.3trn by September 2008, accounting for 92% of the bond market volume in China, PBOC's interbank market appears to be the ideal place for securitisation.

However, this market excludes most securities issued by corporations, including corporate ABS. Such a segmented market severely affects the pace of development of securitisation.

In addition, the global financial crisis caused by the subprime turmoil in the US led to a reasonable argument that securitisation did not function as well as it should have. On the contrary, it encouraged high risk lending and distributed risks globally, with the help of derivative products. With such a concern in the mind of regulators, it is unlikely that China's regulators will loosen control over the securitisation market in the near future.

Corporate Bonds or Corporate ABS

Since a major function of securitisation is to provide cost efficient funding to corporations, it inevitably overlaps with that of corporate bonds.

Without the complex structure of ABS, corporate bonds can already achieve the primary goal of the Chinese bond market - to provide low-cost funding to corporations and to decentralise the credit risk of the banking system, in a much easier way. But that does not necessarily mean that corporate ABS will not be rolled out in the future.

The demand for corporate ABS issuances comes mostly from infrastructure companies, which do not often have investment-grade ratings. Hence it is uneconomic for these companies to issue corporate bonds directly - in consideration of the limited market demand for low-rated securities and the probable barrier of higher associated funding costs. Corporate ABS, meanwhile, can achieve a higher rating through a structural arrangement.

Nevertheless, as mentioned earlier, corporate ABS is not expected to surface in the near future.

Other Concerns

Besides the above, other issues include the following:

- It is not clear whether the current accounting and tax measures will still apply to future transactions after the pilot projects.
- Regulators expect to release certain credit risk from the banking system through securitisation. However, in practice, most securitisation products originated by banks were bought by other banks. As a result, the risk is still left within the banking system.
- It is questionable whether products supplied by a limited number of financial institutions would support the securitisation market effectively, even if PBOC opened up securitisation issuances in the interbank market.

Is Securitisation Really An Economic Option for Originators In China?

When testing securitisation products in recent years, China has seen a trend that bond investors are continuously seeking wider spreads. This has prompted bank originators to question whether it is an economic option to securitise.

Financial Institution Originators

Securitisation has three major benefits for financial institutions in China: (i) it releases capital, (ii) it is a new tool for asset/liability management and (iii) it provides cheap funding.

The China Banking Regulatory Commission (CBRC) is now studying the Basel II Accord to update current measures to calculate the capital required regarding

securitisation. Until detailed terms are released, Fitch will leave the question of capital calculation to future reports.

Under the current circumstance, banks are using securitisation mainly to manage the mismatch between short-term liabilities and long-term assets.

The funding function is also useful for some small- and medium-sized banks and non-bank financial institutions who have limited access to funding. In addition, securitisation can release some lending quota to certain business sectors.

Hence, if the interest spread of the underlying assets can cover the cost of the transaction, securitisation will appeal to financial institutions.

Corporate Originators

The Property Law enacted in 2007 recognised corporate account receivables as eligible collateral. This removed a major roadblock to securitise corporate assets.

Corporate ABS is particularly useful to low-rated corporations, especially those infrastructure corporations that have both stable streams of cash flow and large capital expenditures, such as the owners of toll roads, power plants and water disposal systems.

However, as mentioned earlier, the SAMP has been suspended by the CSRC and no changes are anticipated in this area in the near future.

Investors: Capital Structure and Liquidity

Capital Structure

In China, there are regulations on the types and rating categories of the securitisation notes that investors can invest in. For instance, the China Insurance Regulatory Commission has issued investment guidelines that only allow insurance companies to invest in notes rated at least 'AA(chn)'.

Securitisation notes are often tranching to transfer credit risk, including the equity piece, to different investors with different risk appetites. Given the fact that the major securitisation investors in China can only invest in highly-rated notes for the time being, in the medium term the Chinese securitisation market will still be characterised by highly rated notes rather than notes issued across the whole credit spectrum of the capital structure as seen in the more developed US and European markets.

Liquidity

Similar to most other Asian securitisation markets, the Chinese securitisation market has been illiquid and ABS investors tend to hold the securitisation notes to maturity. The regulators have taken measures to improve the liquidity of securitisation notes, including accepting such notes as eligible collateral for repo purposes and allowing certain categories of securitisations to be traded in the interbank market. This should, in the long run, help to develop liquidity in the secondary securitisation market.

Roads Forward

- To upgrade the current securitisation measures for pilot programmes, including measures for tax, accounting and registration of collateral, as well as laws or general rules.
- To streamline coordination among different regulatory bodies and, in turn, realise a certain degree of integration between the two separate securities markets - the interbank market and the stock exchange market.
- To establish a framework for corporate ABS, or adopt corporate ABS in the current securitisation framework.

- To strengthen investor training and substantially improve the risk management capability of investors.
- To substantially improve information systems and management processes to satisfy the requirements for securitisation, such as credit rating and information disclosure.

Market Outlook

China's securitisation market is still in its very early stages and controlled by the government. While there is a clear strategy to develop the market steadily, coordination among regulators will dramatically affect the path and process of development.

Fitch is cautiously optimistic about the development of the securitisation market for the near future.

Product Types and Issuance

Fitch expects innovations for the second pilot programme and beyond, but balance-sheet CLOs will still be the main product for the near future.

Securitisation innovations will be driven by the regulatory requirements and the market demand for other asset classes, such as SME loans, auto loans, credit card receivables, NPLs, and so on.

Corporate ABS activity will remain quiet for some time, unless regulators can find ways to incorporate it into the current securitisation framework.

Following six securitisations earlier this year, one more securitisation transaction is expected to be issued in 2008. After that, regulators may take time to review the market again.

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