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## Asset Securitization: Is It a Resolution Option for China's Non-Performing Loans?

Hui (Hannah) Cao

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## NOTES

### ASSET SECURITIZATION: IS IT A RESOLUTION OPTION FOR CHINA'S NON-PERFORMING LOANS?

#### I. INTRODUCTION

China's banking industry has been straddled with a staggering number of non-performing loans ("NPLs").<sup>1</sup> These bad loans were extended by China's state banks to inefficient state-owned enterprises ("SOEs"), as well as failed real estate projects during the time of economic overheating in the mid 1990s.<sup>2</sup> In order to overhaul its fragile banking system, the Chinese government has taken a series of measures over the past decade to clean up the balance sheets of four major state banks.<sup>3</sup> One significant step was the creation of four Asset Management Companies ("AMCs") in 1999, which purchased at face value about USD170 billion of NPLs from four major state banks with the ultimate task of disposing of these assets.<sup>4</sup> To date, the AMCs have recovered about a quarter of the transferred portfolio through various techniques including loan resale, public auction, debt restructuring, and debt to equity swaps.<sup>5</sup> Recently, with governmental support, the Chinese AMCs have also begun

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1. The official NPL ratio at four major Chinese state banks was given in 1999 as 25% of the total loans outstanding. For several years, the government denied the scale of the problem and dismissed unofficial estimates that put the ratio at 40% or more of the total loans outstanding. See *infra* notes 35–39 and accompanying text. Nicholas Lardy, a China expert at the Brookings Institution, however, recently estimated China's NPLs to be USD500 billion, or about 50% of the total. *Casino Capital: China's Financial Markets Are Wild and Often Less Than Wonderful*, in *THE WEAKEST LINK: A SURVEY OF ASIAN FINANCE* 10, 12 (supplement to *ECONOMIST*, Feb. 8, 2003) [hereinafter *Casino Capital*].

2. See *infra* notes 40–47 and accompanying text.

3. See *infra* notes 60–63 and accompanying text.

4. See *infra* notes 65–71 and accompanying text.

5. See *Casino Capital*, *supra* note 1, at 12.

to explore asset securitization as an alternative for the expeditious and efficient resolution of NPLs under their charge.<sup>6</sup>

Asset securitization<sup>7</sup> refers to a specific form of financial transaction in which an originator pools certain types of illiquid assets (typically loans or receivables) and transfers them to a special purpose vehicle ("SPV").<sup>8</sup> The SPV, in turn, issues securities (usually bonds, but can also be equities) collateralized or backed by the transferred assets.<sup>9</sup> The SPV pays investors of these asset backed securities ("ABSs") interest and principal out of the cash flow arising from the underlying assets.<sup>10</sup> Investors then purchase the securities based on their evaluation of the transferred assets' risk, without concern with the originator's financial condition.<sup>11</sup>

Securitization is beneficial to originators through risk transferring. For corporations, securitization offers a new and potentially cheaper form of financing.<sup>12</sup> For financial institutions, such as banks that hold large loan portfolio, securitization not only provides alternative financing, but also allows them to address regulatory requirements, such as capital adequacy and lending limits.<sup>13</sup> Therefore, a financial institution originator may achieve a good match between assets and liabilities.<sup>14</sup>

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6. Interview with Kaisheng Yang, Chairman, China Huarong Asset Management Corporation, in Beijing, China (Jan. 9, 2003) [hereinafter Interview with Yang].

7. In this Note, asset securitization and securitization are used interchangeably. For a general discussion on securitization, see TAMAR FRANKEL, *SECURITIZATIONS: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES* (1991 & Supp. 1999); STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (3d ed. 2002) [hereinafter SCHWARCZ, *STRUCTURED FINANCE*]; THE SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 2d ed. 1996 & Supp. 1999); Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 *TULANE L. REV.* 101 (1997); Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 *WASH. U. L.Q.* 1061 (1996); and Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 *STAN. J.L. BUS. & FIN.* 133 (1994) [hereinafter Schwarcz, *Alchemy*].

8. SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 7, at 1–3.

9. Schwarcz, *Alchemy*, *supra* note 7, at 135.

10. *Id.*

11. *Id.*

12. IAN H. GIDDY, *ASSET SECURITIZATION IN ASIA 2* (2000), available at <http://pages.stern.nyu.edu/~igiddy/ABS/absasia.pdf>.

13. According to the Basel Committee on Banking Supervision, banks that securitize assets are able to accomplish several objectives: (1) reduce regula-

For investors, ABSs provide better yields than those on comparable corporate bonds and enable them to diversify their investment portfolios.<sup>15</sup> In addition, the investors' risk preferences may be accommodated through special deal structures.<sup>16</sup> Finally, since the ABS issues usually are large and have high credit ratings as a result of credit enhancements, these securities tend to be liquid and may be actively traded in secondary markets.<sup>17</sup>

In a typical asset securitization transaction, the SPV issues securities backed by "good" assets with a proven track record of repayment streams.<sup>18</sup> During the period of 1989 to 1995, however, the Resolution Trust Corporation ("RTC"), a special agency sponsored by the United States ("U.S.") government, successfully utilized the asset securitization to dispose of under- and non-performing loans taken over from failed savings and loan associations.<sup>19</sup> The U.S. experience has since inspired some Asian economies, such as Japan, Korea, and Taiwan, to employ securitization as a method to dispose of their bad bank loans.<sup>20</sup>

This Note argues that given the magnitude and urgency of China's NPL problem, the AMC's should explore all possible resolution methods, including securitization, to prevent their portfolios from rapidly decreasing in value like a melting ice cream.<sup>21</sup> The Chinese AMC's, however, may only be able to utilize asset securitization to recover certain suitable NPLs, because there exist substantial obstacles to a large scale NPL se-

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tory capital requirements; (2) obtain an additional source of funding, generally at lower cost; (3) enhance financial ratios; (4) manage portfolio risk; (5) diversify their portfolios. See BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: ASSET SECURITIZATION 1 (2001), available at <http://www.bis.org/publ/bcbzca06.pdf>.

14. GIDDY, *supra* note 12, at 2.

15. *Id.*

16. *Id.* at 3-4.

17. *Id.* at 3.

18. See SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1-2; see also GIDDY, *supra* note 12, at 3.

19. See *infra* notes 156-58 and accompanying text.

20. See discussion *infra* Part V.

21. Kaisheng Yang called the value decrease of NPL portfolio as "ice cream effect:" the bad loans are like "an ice cream you are holding in your hand, which, if you hold it too long, will melt away." Interview with Yang, *supra* note 6.

curitization program in China. The most prominent hindrances include the peculiar nature of Chinese NPLs, the immaturity of the capital markets, and the inadequacy of China's existing legal infrastructure.

Part II of this Note provides an overview of China's banking system and NPL problem. Part III then introduces the general features of asset securitization along with a cost-benefit analysis. Part IV examines the desirability and feasibility of distressed loan securitization, followed by a case study of the RTC securitization program. Part V discusses the securitization development in East Asia with some details on the Japanese and Korean cases. Part VI considers the market conditions for NPL securitization in China, identifying as securitizable certain types of NPLs held by the Chinese AMCs. Part VII examines China's current legal and regulatory framework relevant to securitization, and proposes for special legislation to facilitate securitization development. Part VIII concludes by stressing that China must further liberalize its capital markets and establish a transparent legal system in order to pave the way for launching NPL securitization market.

## II. CHINA'S NON-PERFORMING BANKING LOANS

This Part first provides an overview of China's banking system. It then discusses the seriousness of the NPL problem, as well as its negative impact on the country's financial stability and economic growth. This Part ends with a review of the Chinese government's step to attack the NPL problem.

### *A. Evolution of China's Banking Industry*

China's banking sector saw considerable institutional transformation in the last two decades of the twentieth century.<sup>22</sup> For a long time, China lacked a sophisticated banking system. Until the early 1980s, the People's Bank of China ("PBoC") performed the mixed functions of both a central and an operational bank. In 1984, the PBoC's operational business, consisting mainly of short-term industrial and commercial credit as well as related payments (i.e., granting loans for working capital),

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22. For a comprehensive discussion on the evolution of China's banking system, see NICHOLAS LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION ch. 3 (1998).

were assigned to a newly established state bank, the Industrial and Commercial Bank of China (“ICBC”). Accordingly, PBoC started to perform solely the functions of the nation’s central bank.<sup>23</sup> ICBC, along with the Agricultural Bank of China (“ABC”), China Construction Bank (“CCB”), and the Bank of China (“BOC”), operated through the late 1980s and 1990s as the four major so called “specialized” state banks (hereinafter “the big four”), dominating the country’s financial landscape.<sup>24</sup>

During the 1990s, the Chinese government accelerated the process of the banking system reform. The Central Banking Law enacted in 1995 formally granted the PBoC the legal authority to function as a central bank. Today, the PBoC holds the role as the lead supervisor of China’s financial institutions.<sup>25</sup> In addition, since 1994, the government began to transform the big four into commercial entities. At the same time, the prior division of their business scope along the client sector line gradually diminished, allowing more competition among the big four. Beginning in the mid 1980s, the government relaxed restrictions on the banking market entry, granting licenses to a number of new commercial banks and nonbank financial institutions. Foreign banks were also permitted to establish their operations in China, but were subject to severe restriction on both geographic and sectoral scope of domestic currency business.<sup>26</sup> Up to the year 2000, only 32 licenses were granted to foreign banks to handle such business, all of which are in Shanghai and Shenzhen.<sup>27</sup> An even smaller group of them is allowed to borrow from and lend to local banks. When

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23. *Id.* at 63–62.

24. *Id.* at 80.

25. A complex web of government authorities oversees the country’s banking activities. The regulatory framework can be generally broken down among the PBoC, the Ministry of Finance (“MOF”), the China Securities Regulatory Commission (“CSRC”), the State Administration of Foreign Exchange (“SAFE”), the Ministry of Foreign Trade and Economic Cooperation (“MOFTEC”) and the State Economic and Trade Commission (“SETC”). Each regulator, however, has individual preferences and objectives in its regulatory duties. ERNST & YOUNG, AN OVERVIEW OF THE NON-PERFORMING ASSET MARKET IN THE PEOPLE’S REPUBLIC OF CHINA 10 (2001) (on file with the author) [hereinafter ERNST & YOUNG REPORT].

26. Karen Chan, *Development in Banking Law 2000: Global Banking — Asia/Pacific*, 20 ANN. REV. BANKING L. 32, 42–43 [hereinafter *Asian Banking 2000 Review*].

27. *Id.* at 43.

China acceded to the World Trade Organization (“WTO”) in the end of 2001, it committed itself to opening up its financial sector to the outside world. Accordingly, after a five-year transitional period, the Chinese government will eliminate both geographic and customer limitations on foreign banks in conducting the local currency business, and foreign banks will eventually enjoy national treatment.<sup>28</sup>

Although the institutional landscape has become more complex,<sup>29</sup> the Chinese banking sector remains underdeveloped, even when compared to other Asian markets. The banking sector’s main clientele is the state sector. For example, state banks extend most loans (about 80%) to state-owned enterprises, while the private sector receives less than 5% of total lending.<sup>30</sup> The services to their customers are limited to basic deposit, lending, and transaction banking.<sup>31</sup> Household depositors receive few financial services beyond maintaining their savings accounts. In fact, basic retail banking services, such as checking accounts for households, are rare, even in the largest cities. Credit cards, home mortgages, and car loans are still in their infancy stage. Meanwhile, other types of consumer credit still do not exist.<sup>32</sup>

### *B. The NPL Problem*

China’s effort to modernize its banking system has been burdened by mountains of bad loans sitting on the books of major state banks.<sup>33</sup> Chinese scholars estimate that the proportion of

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28. *Id.*

29. Currently, the structure of China’s banking system consists of 4 state commercial banks, 3 policy banks, 10 national joint-stock commercial banks, 4 asset management corporations, about 88 city-based commercial banks, 3,240 urban credit cooperatives, more than 41,500 rural credit cooperatives, and approximately 162 foreign banks that maintained branches or representative offices. ERNST & YOUNG REPORT, *supra* note 25, at 8.

30. *The Long March to Reform China’s State Firms*, ECONOMIST, Sept. 30, 2000, available at 2000 WL 8143861.

31. Stephen M. Harner, *China Watch: Beijing Blocks the Banks*, ASIAN WALL ST. J., July 20, 2000, at J10, available at 2000 WL 23745833.

32. LARDY, *supra* note 22, at 82–83.

33. For a thorough discussion of China’s NPL problem, see Jianbo Lou, *China’s Bank Non-Performing Loan Problem: Seriousness and Causes*, 34 INT’L LAW. 1147 (2000).

NPLs<sup>34</sup> to overall bank assets has ranged from 10–40%.<sup>35</sup> In 1999, the governor of PBoC, Dai Xianglong, officially recognized that the ratio of NPLs to total outstanding loans at the big four was 25%.<sup>36</sup> The Bank for International Settlements, in a 2002 report, estimated the NPLs accumulated by China's big four to be 42% of the total.<sup>37</sup> This figure is comparable to the highest levels of 40% to 60% for South Korea and Indonesia during the height of the 1997-98 financial crisis.<sup>38</sup> In 2001, Standard & Poor's ("S&P"), a credit rating agency, estimated that it would take about USD540 billion, half of China's annual GDP, to properly recapitalize the big four.<sup>39</sup>

Although an in-depth discussion of the causes of China's NPL problem is beyond the scope of this Note, a brief summary is helpful. Historically, the NPL problem roots from the prior regime of command economy. For decades during the pre-reform era, state banks served as mere conduits for the quasi-fiscal operations of government institutions, extending easy credit to loss-making SOEs, providing subsidy loans for agricultural procurement programs, and financing a variety of public investment projects according to the needs of state planning.<sup>40</sup>

Banking reform did not prevent NPLs from snowballing. While struggling to establish themselves as truly autonomous entities, the state banks were only to find the impossibility of

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34. The identification of NPLs referred to here is made under China's old three tier loan classification system. The total figure of NPLs includes loans that were overdue for less than one year and might be recovered. The main body of the portfolio, however, consists of doubtful and bad loans that would have to be written off. Since 1998, a new five level system, more in line with the international standard, has started to be implemented in the industry. *See id.* at 1192 n.4.

35. *Id.* at 1147.

36. *See id.* *See also* Peter Montagnon and James Harding, *Chinese Central-Bank Governor To Reduce Bad Debt*, FIN. TIMES, Sept. 13, 1999, available at 1999 WL 21147750.

37. GUONAN MA & BEN S.C. FUNG, CHINA'S ASSET MANAGEMENT CORPORATIONS 2 (Bank for International Settlements, Working Paper No. 115, Aug. 2002), available at <http://www.bis.org/publ/work115.pdf> [hereinafter BIS WORKING PAPER].

38. *Id.* *See also*, *Review and Outlook: the Care and Feeding of China's Banks*, ASIAN WALL ST. J., Oct. 7, 2002, at A11, available at 2002 WL 23018599 [hereinafter *Review and Outlook*].

39. *Id.*

40. Fred Hu, *Sense of Urgency, A Race Against Time*, ASIAN WALL ST., Feb. 11, 2002, at J8, available at 2002 WL 3344150 [hereinafter *Sense of Urgency*].



allocating credit purely based on commercial considerations.<sup>41</sup> They continue to face strong, although perhaps less outright,<sup>42</sup> political pressure to rescue the financially deteriorating SOEs.<sup>43</sup> Furthermore, the banks' problem of lax internal credit risk control persists,<sup>44</sup> even though most banks have begun to pay more attention to the borrowers' repayment capability and loan collateral's quality. The lack of effective internal control and external oversight, coupled with the difficulty of obtaining reliable financial information on the SOE borrowers, seriously constrained the ability of state banks to prudently assess credit risk, resulting in the declining of their loan quality.<sup>45</sup>

In addition to the soft loans made to the loss producing state owned factories, NPLs also include failed commercial real estate loans. In the mid 1990s, a time of economic overheating, many Chinese banks lent excessively to commercial real estate development projects, mainly in Shanghai, Beijing and some other coastal cities.<sup>46</sup> A considerable portion of such loans became nonperforming when the overbuilding resulted in a market collapse.<sup>47</sup>

The NPL problem has a serious negative impact upon both China's banking reform and its overall economic growth. First, the mounting NPL portfolios on the big four's balance sheets stand as a formidable obstacle to their true commercialization. The huge amount of bad loans in fact contributed to the big four's profitability decline, undermining their competitiveness.<sup>48</sup> Significantly, the staggering figure of NPLs has already

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41. *Id.*

42. In 1998, the PBoC terminated the long-standing credit ceiling system. See Dai Xianglong, *Wei Jianli Xiandai Jinrong Tixi, Jinrong Zhidu he Lianghao de Jinrong Chixu er Nuli* [The Objectives of a New Round of Financial Reform and Development], 2 *ZHONGGUO JINRONG [CHINA FIN.]* 6 (1998).

43. See *Sense of Urgency*, *supra* note 40 (pointing out that the fundamental cause of the NPL problem lies in the deteriorating performance and loss making of many SOEs, the state banks' main clientele). See generally LARDY, *supra* note 22, Ch. 2.

44. *Sense of Urgency*, *supra* note 40.

45. *Id.*

46. See LARDY, *supra* note 22, at 195–97.

47. See *id.*

48. The average profit margin of the big four during the period from 1995 to 1997 was only 0.26% and showed a decreasing tendency. In contrast, the profitability of the ten new commercial banks during the same period was 1.70% and showed an increasing tendency. One of the reasons that these

made the big four technically insolvent.<sup>49</sup> Liquidity, however, is currently not a problem facing China's state banks. Two reasons explain this coexistence of technical insolvency and high liquidity in the banking sector: (1) high domestic household savings,<sup>50</sup> and (2) limited investment outlets in the underdeveloped domestic capital markets.<sup>51</sup> The big four are kept afloat mainly on governmental support and the public's confidence in state banks.<sup>52</sup> Given the weight the big four carry in the entire banking system,<sup>53</sup> any wavering of public depositors' faith could cause a major bank failure, and the resultant systemic financial debacle would lead China into turmoil.<sup>54</sup>

The NPL problem also stymies China's real economy. On the microeconomic level, the accumulation of NPLs on banks' balance sheet distorts the incentives for both banks and SOEs. The so-called "adverse selection" influencing banking lending decisions<sup>55</sup> fostered the SOEs' excessive reliance on state banks, diminishing their willingness and capability to adjust production in response to market signals.<sup>56</sup> From a macroeconomics

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newcomers outperformed the big four is that they had a very low NPL level. It is estimated that the emerging commercial banks have NPLs accounting for only 2.3% of their outstanding loans. See Lou, *supra* note 33, at 1148, nn.14–15.

49. See LARDY, *supra* note 22, at 119.

50. See Lou, *supra* note 33, at 1159–62. In 1997, bank deposits and savings accounted for more than 80% of all household financial assets, securities only accounted for approximately 10%, and cash and other assets less than 10%. See Statistics Department of the PBoC, *An Analysis of the Direct Finance of Chinese Enterprises*, 9 CHINA FIN. (Beijing) 24 (1998).

51. See Lou, *supra* note 33, at 1159–62.

52. Commentators have observed that China's low national debt, high savings rate, and reform momentum have so far forestalled a disastrous crisis of confidence in the banking system. See, e.g., Hugo Restall, *Examining Asia: Selling Debt, Restarting Reform*, ASIAN WALL ST. J., Dec. 19, 2001, at J11, available at 2001 WL 29659268.

53. As of 1998, the big four held 68% of the nation's deposits, 77% of all loans, and 75% of total banking assets, and employed 66% of those working in the banking sector. See Lou, *supra* note 33, at n.23.

54. See LARDY, *supra* note 22, at 201–02.

55. See Lou, *supra* note 33 at 1151–52

56. The "adverse selection" refers to the distortion in the process of loan decision making. Because of the heavy exposure of state banks to SOE borrowers and the large amount of NPLs in proportion to the bank capital, the bank managers, in fear of the banks' own failure, were forced to extend new workout loans to the ailing SOEs enabling them to service the existing outstanding debts. The managers of highly leveraged SOEs, on the other hand,

perspective, the soundness of China's financial sector has a major influence on the health of the overall economy.<sup>57</sup> China has a bank-centric financial system, where banks play a key role of channeling funds from households to industry and commerce. The banks' share of financial intermediation is almost nine-tenths, a ratio exceeding that of almost all other Asian economies.<sup>58</sup> Any contraction of bank credit therefore could significantly affect China's real economic growth. Some economists, for example, believe that the 1998 economic slowdown in China was partially due to the banking sector stress caused by the cautiousness of banks in their lending in response to the alarm of the Asian financial crisis.<sup>59</sup>

### *C. Steps to Resolve the NPL Problem*

In the mid-1990s, the Chinese government began taking steps aimed at reversing the deterioration of state banks loan assets. It recognized that one reason for the existence of nonrecoverable loans was government pressure on state banks to make loans to politically important SOEs without giving regard to their repayment capability. As a result, the government set up three policy banks in 1994 to take over the pure policy lending function from the big four.<sup>60</sup> The government hoped that after creating these new policy banks, the big four would be run along more commercial lines. Subsequently, the 1997–1998 financial crisis that afflicted many of China's East Asian neighbors awakened the Chinese leaders to the dangers that a fragile banking sector could pose to the country's financial security and economic development.<sup>61</sup> Although China averted a crisis largely due to its financial insulation,<sup>62</sup> the government realized the urgent need to take sweeping measures in order to avert a systemic financial debacle. A significant step was taken

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had no incentive to scrutinize their projects or to promote the firms' profitability, because they knew that banks have no choice but to keep lending. *Id.*

57. *Id.* at n.33 (citing literature discussing a significant correlation between financial development and growth in China and other countries).

58. See LARDY, *supra* note 22, at 16.

59. See Lou, *supra* note 33, at 1153.

60. See *Review and Outlook*, *supra* note 38.

61. In late 1997, a top-level national financial conference was held in Beijing in response to the rapidly unfolding Asian financial crisis. See *Sense of Urgency*, *supra* note 40.

62. See LARDY, *supra* note 22, at 197–98.

in 1998, when the Ministry of Finance (“MOF”) issued RMB270 billion (USD33 billion) of bank restructuring bonds to recapitalize the big four, boosting their capital adequacy ratios to the internationally accepted level of 8%.<sup>63</sup>

However, with little change in the incentive structure at both the state banks and the SOEs, bank loan quality continued to decline and the big four’s capital once again evaporated.<sup>64</sup> Consequently, the top priority of China’s financial reform agenda was to promptly resolve the NPL problem. In 1999, the Chinese government created four asset management corporations (one for each of the big four),<sup>65</sup> taking a page from the U.S. experience a decade earlier after the savings and loans crisis.<sup>66</sup> The AMC’s purchased at book value from the big four at total of RMB1.3 trillion (USD169 billion) NPLs extended before the end of 1995.<sup>67</sup> To finance this purchase, MOF issued RMB10 billion (USD1.2 billion) of 10-year bonds for each of the four AMC’s, and PBoC also provided cash credit.<sup>68</sup> This massive transfer of NPLs from the big four’s balance sheets to that of the AMC’s effectively provided a second round of recapitalization for the big four.<sup>69</sup>

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63. See *Review and Outlook*, *supra* note 38. See also, Jun Ma, *Financial Liberalization: Slow and Steady*, 28 CHINA BUS. REV. 1216 (May 1, 2001), available at 2001 WL 13260974.

64. See *Review and Outlook*, *supra* note 38.

65. These AMC’s are Huarong Asset Management Company for ICBC, China Xinda Asset Management Company for CCB, China Great Wall Asset Management Company for ABC, and China Orient Asset Management Company for BOC. See BIS WORKING PAPER, *supra* note 37, at 1.

66. China modeled its AMC’s along the lines of the Resolution Trust Corporation (RTC) created in 1989 by the United States government. See *supra* note 157 and accompanying text.

67. *Id.*

68. *Id.* at 4.

69. The final cost to the Chinese government of the eventual write-offs plus the interest payments on the bonds could easily reach RMB 1 trillion (USD121 billion). Fitch IBCA, in their 2000 Sovereign Debt Rating Report, estimated that the worst-case scenario based on systemic NPLs of 40% and a 30% recovery rate would suggest a one-off charge equal to 20–25% of 1999 GDP. This scenario would raise the public debt-to-GDP ratio to 40–50%, roughly on par with Thailand, while higher interest payments could widen the budget deficient by an estimated 1–2% of GDP. Such a huge burden, which may still be substantially understated, would without doubt considerably strain the government’s fiscal resources, even though the majority of the costs will not need to be realized until the AMC bonds are redeemed at maturity in 10 years. ERNST & YOUNG REPORT, *supra* note 25, at 18.

The Financial Asset Management Company Regulation ("AMC Regulation") promulgated in November 2000 by the State Council, the executive branch of the central government, subjects the AMCs to the concurrent supervision of the PBoC, MOF, and the China Securities Regulatory Commission ("CSRC").<sup>70</sup> The AMC Regulation delegates the AMCs with an ultimate task of recovering the transferred bad loans to the fullest extent.<sup>71</sup>

Major disposition options granted by the government to the AMCs include debt-to-equity swaps ("DESs"), loan resale, and debt restructuring.<sup>72</sup> Besides domestic sales, DESs have been one of the most significant actions taken by the AMCs to resolve bad loans. By the end of 2000, the four AMCs purchased RMB1, 488 billion (USD483.8 billion) of NPLs and completed 587 swaps.<sup>73</sup> DES deals completed by the AMCs, however, have received much criticism.<sup>74</sup> The DESs were conducted based on the assumption that relieving the SOEs from the burden of debt servicing would improve their financial positions because many of them were highly overleveraged.<sup>75</sup> It was hoped that through swaps the SOEs could eventually make public equity offerings to pay back the creditors turned shareholders, the AMCs, with their newly raised capitals. While this strategy may be effective in cases where the companies were financially distressed but potentially viable, there is a real danger that in many other cases the debt embedded SOEs may turn the DESs into a shell game of debt forgiveness.<sup>76</sup> Experts have pointed out that a change in SOE capital structure would not by itself improve the

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70. Financial Asset Management Company Regulation, art. 4 (Nov. 20, 2000), available at <http://www.chamc.com.cn/English/index.asp>.

71. *Id.* art. 3.

72. *Id.* art. 10.

73. Huarong has bought RMB505.6 billions (USD61.1 billion) NPLs, and completed 333 debt-for-equity swaps, Xinda RMB370 billion (USD44.7 billion), 168 swaps, Orient RMB266.5 billion (USD32.2 billion), 65 swaps, and Great Wall RMB345.8 billion (USD41.8 billion), 21 swaps. Nicholas Howson, *The AMCs' Debt-for-equity Swaps: Opportunity for Foreign Capital?*, 28 CHINA BUS. REV. 56 (2001).

74. See, e.g., *id.*; *Review and Outlook*, *supra* note 38; Fred Hu, *China's Banking Reform: Pitfalls Ahead*, ASIAN WALL ST. J., Nov. 24, 1999, at J8, available at 1999WL-WSJA 30190857 [hereinafter *Pitfalls Ahead*].

75. The SOE average debt-to equity ratio is estimated to be in excess of 400% by some measures. See *id.*

76. *Id.*

managers' behavior or put the ailing companies on sound footing. Given the lack of meaningful means for the AMC's to enforce their shareholder rights, delinquent SOE borrowers have a strong incentive to abuse DESs to evade debts, further contaminating the already weak credit culture in China's state sector economy.<sup>77</sup>

The AMC's have also used portfolio sale to recover NPLs. Until recently, the AMC's made only a few sale transactions to domestic buyers.<sup>78</sup> Late in 2001, Huarong Asset Management Corporation ("Huarong"), the largest of the four AMC's in China, nailed down a landmark auction sale with two groups of major international investment banks.<sup>79</sup> This first international NPL sale in the country<sup>80</sup> was hailed by financial analysts as "a breakthrough for the management of distressed assets in China."<sup>81</sup> A year later, near the end of 2002, Huarong finally won approval of the deal by China's relevant financial authorities, including the PBoC, MOF and MOFTEC.<sup>82</sup> The foreign

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77. *Id.*

78. ERNST AND YOUNG REPORT, *supra* note 25, at 18.

79. The AMC's purchased NPLs from the big four at the loans' face value, perhaps reflecting the Chinese government's hesitation to recognize the low recoverability of the NPLs. Outside observers pointed out that this no discount transfer cast a serious cloud over the valuation of any further asset transfer by the AMC's to investors, because few buyers would purchase the NPLs at anything close to the face value, with no discount given the assets' real value. Edward S. Steinfeld, *Free Lunch or Last Supper? China's Debt-Equity Swaps In Context*, 27 CHINA BUS. REV. 2227 (2000).

80. *China Completes Initial NPL Sale*, BUS. WORLD, Dec. 13, 2001, available at LEXIS News.

81. James Kynge, *Consortium Agrees Deal Over Chinese NPLs*, FIN. TIMES, Nov. 30, 2001, at 31, available at LEXIS News.

82. *Foreign Capital Allowed To Handle Non-Performing Assets in China*, ASIA PULSE, Dec. 3, 2003, available at LEXIS News [hereinafter *Foreign Capital Allowed*].

With the green light from regulators, two joint ventures are planned to be launched in economic development zones in Beijing or Shanghai. The First United AMC, founded by Huarong and a Morgan Stanley-led investment banking group will be responsible for resolving four packages of NPLs amounting to RMB10.8 billion (or USD1.30 billion), which covers problem loans in 254 companies in 18 provinces. The Rongsheng AMC will be launched by Huarong and Goldman Sachs and in charge of a package of RMB1.97 billion NPLs (or USD238.2 million) made to 44 enterprises in 13 provinces. *Huarong AMC Teams With Foreign Giants to Dispose of NPLs*, BUS. DAILY UPDATE, Dec. 10, 2002, available at LEXIS News [hereinafter *Teams with Foreign Giants*].

partners,<sup>83</sup> who paid nine cents on the dollar to Huarong,<sup>84</sup> are able to take controlling stakes.<sup>85</sup> According to a profit sharing plan, the income received by the partners from the follow-up disposals will differ at various stages. If recovery goes extremely well, Huarong could recoup as high as 21% of the portfolio's face value.<sup>86</sup> Significantly, this deal tested the Chinese government's willingness to comply with the international valuation practice, as there was a longtime concern within the government that selling NPLs at a large discount to foreigners amounted to stripping state assets.<sup>87</sup> The official approval of this transaction evidenced that "pragmatism on pricing the debts ha[d] won the day."<sup>88</sup> As outside observers hoped, with more international exposure, China's NPL market would become better regulated and more transparent.<sup>89</sup> In addition, incoming foreign participants would also bring to China their proven techniques of distressed debt resolution, such as asset securitization discussed below.

### III. OVERVIEW OF ASSET SECURITIZATION

Subpart A reviews the background of asset securitization. Subpart B then compares the benefits of securitization with its costs.

#### *A. Background of Securitization*

Securitization is a financial innovation that transforms illiquid income-generating assets into securities with a second mar-

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83. Four of the five blocks of NPLs were bought by a consortium including Morgan Stanley, Lehman Brothers, Salomon Smith Barney and KTH Investments, Goldman Sachs bid for another block. *Id.*

84. *Id.*

85. *Id.*

86. See Restall, *supra* note 52. In line with international practice, two disposal service firms will also be established to deal with the NPL disposal on behalf of the two joint ventures. The business scope of the two ventures includes NPL management, transfer, exchange, sale and restructuring, as well as debt collection, but no DESs, or direct investment services and other financial services, such as lending or deposits and settlement, are permitted. *Teams with Foreign Giants*, *supra* note 82.

87. Kynge, *supra* note 81.

88. Restall, *supra* note 52.

89. *Foreign Capital Allowed*, *supra* note 82.

ket.<sup>90</sup> In a typical securitization transaction, an originator company effects a “true sale” of its rights in receivables or other financial assets to a special purpose vehicle, which then issues securities backed by the transferred assets.<sup>91</sup> Investors in the capital markets then purchase these securities at prices based on the ABSs’ credit rating.<sup>92</sup> The SPV uses the ABS issuance proceeds to pay for the financial assets.<sup>93</sup> Sometimes mechanisms of credit enhancement such as letters of credit, third party guarantees, or over-collateralization are employed to provide investors with additional protections against the risk of default payment.<sup>94</sup> In many cases, the originator also acts as servicer for the underlying assets, given its collecting expertise.<sup>95</sup>

Securitization first appeared in the 1970s, when the U.S. government took the initiative to develop a secondary market for residential mortgage loans.<sup>96</sup> Over the next three decades, the scope of securitization greatly expanded to encompass a wide range of assets, including student loans, credit card loans, automobile loans, airplane leases, commercial and recreational equipment leases and loans, health care receivables, music royalty receivables, and non-performing loans.<sup>97</sup> According to the U.S. Securities and Exchange Commission, securitization has

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90. Joseph Shenker & Anthony Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1371–74 (1991).

91. A true sale is a complete divestiture of ownership — the transferor no longer retains any right, title or interest in the property. It is intended to have the effect of removing the assets transferred from the transferor’s estate under section 541 of the U.S. Bankruptcy Code. Therefore, an important feature of an SPV is its bankruptcy-remoteness. The Comm. on Bankr. and Corp. Reorganization of the Ass’n of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 541 [hereinafter *Structured Financing Techniques*]. To gain a general understanding of true sale and the related issue of bankruptcy remoteness, see SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, Chs. 3 & 4.

92. Schwarcz, *Alchemy*, *supra* note 7, at 136 (describing securitization as a process whereby a company uses an SPV to “raise[] funds by issuing securities, — usually debt or debt-like securities — and [then uses] the receivables purchased the originator to repay investors in the future”).

93. *Id.*

94. *Id.*

95. See GIDDY, *supra* note 12, at 2.

96. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1-7 to 1-8.

97. *Structured Financing Techniques*, *supra* note 91, at 539.



become “one of the dominant means of capital formation in the United States.”<sup>98</sup>

### B. *Benefits and Costs of Securitization*

Some commentators view securitization as a sort of “alchemy” that benefits both the investors and originator.<sup>99</sup> For investors, securitization provides an opportunity to invest in diversified portfolio while undertaking a comparably low risk thanks to credit enhancements.<sup>100</sup> Furthermore, the transaction structure can be flexibly designed to accommodate the needs of investors with different or unique investment preferences.<sup>101</sup>

Reducing financing costs constitutes one of the primary benefits for an originator.<sup>102</sup> In a securitization transaction, the interest rate paid to the ABS investors is less than that paid in a straight debt issuance or equity offering by the originator.<sup>103</sup> This is possible because the return that ABS investors demand in a given deal is a function of only the credit rating of the securities backed by transferred assets.<sup>104</sup> As a result, the originator’s creditworthiness is not a concern to the ABS investors.<sup>105</sup> A high ABS credit rating can thus be achieved because of the SPV’s isolated credit risk, as well as a careful structural design

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98. Investment Company Act Release No. 19,105, [1992 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 85,062, at 83,500 (Nov. 19, 1992).

99. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1-2. Schwarcz argued that securitization is not a zero-sum game, in the sense that the originator’s benefits do not merely offset another person’s loss. He believed that securitization creates a genuine cost reduction for all parties. *See id.* at App. A: *Is Securitization A Zero-Sum Game?* *See also*, Frederick Feldkamp, *Asset Securitization, The Alchemist’s Dream*, in SECURITIZATION YEARBOOK 2000 1 (supplement to INT’L FIN. L. REV., Oct. 2000); Shenker & Colletta, *supra* note 90; Howard Felson, *Closing the Book on Jusen: An Account of the Bad Loan Crisis and a Chapter for Securitization in Japan*, 47 DUKE L. J. 567, 587 (1997).

100. *See* GIDDY, *supra* note 12, at 2–3.

101. *Id.* at 3–4.

102. *Structured Financing Techniques*, *supra* note 91, at 530–31.

103. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1–9.

104. *Id.* The most accepted rating agencies are Standard & Poor’s Rating Group (“S&P”) and Moody’s Investors Service, Inc. (“Moody’s”). Another well-known agency is Fitch, Inc. For a general discussion on rating in securitization, see section 8:9 of SCHWARCZ, STRUCTURED FINANCE, *supra* note 7. *See also* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV 1 (2002) [hereinafter *Rating Agency Paradox*].

105. *Id.*

and credit enhancements.<sup>106</sup> Accordingly, an originator who is unrated or rated below investment grade can nonetheless through an SPV issue ABSs with an investment grade rating.<sup>107</sup> Even for an originator that itself has an investment grade rating, cost savings may be achieved in securitization if the SPV can issue ABSs with an even higher rating.

Another advantage is that the originator can attract broader range of investors through a flexible transactional structure.<sup>108</sup> A creative deal designer may effectively utilize over-collateralization, revolving asset pools, or subordinated interests to reconstructed ABS cash flows and maturity feature, in order to cater to both risk averse and risk seeking investors.<sup>109</sup> The resultant wider market reach may then transform into higher demand for and better liquidity of the ABSs.<sup>110</sup>

Securitization transactions, however, incur substantial transaction costs. There are, for example, costly fees payable to the credit rating agencies, attorneys, investment bankers, and accountants.<sup>111</sup> Credit enhancement fees, annual reporting and printing fees also add to the long list of expenses.<sup>112</sup> Accordingly, some commentators argue that unless funds raised in a transaction exceed USD50 million, the benefits can hardly justify the extremely high transaction costs.<sup>113</sup>

In general, an originator will need to weigh potential cost savings against the transaction costs before launching a securitization transaction.<sup>114</sup> In other words, a company contemplating securitization should compare the expected differential between interest payable on alternative funding options and that on ABSs issued by an applicable SPV, with the expected difference in transaction costs between the alternative financing.<sup>115</sup>

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106. *Structured Financing Techniques*, *supra* note 91, at 533–34.

107. *Id.*

108. *Structured Financing Techniques*, *supra* note 91, at 531.

109. *Id.*

110. The availability of funds in developed markets is usually not as limited as in the private markets, and certain issues presented in the private markets, such as lending limits of a particular financing institution, do not exist in the capital markets. *Id.*

111. *See* Felson, *supra* note 99, at 589.

112. *Id.* at 599.

113. *Id.* at 587.

114. SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 7, at 1–11.

115. *Id.*

## IV. SECURITIZATION OF DISTRESSED LOANS

Subpart A discusses the desirability of distressed loan securitization from both the originator and investors' perspectives. Subpart B then considers four factors important to the feasibility of distressed loan securitization. Subpart C studies the RTC securitization program.

A. *Desirability of Distressed Loan securitization*

Generally, the business of securitizing distressed loans<sup>116</sup> becomes more attractive when lending banks see a rise in corporate defaults within their portfolios, and therefore the banks become concerned with their financial performances negatively affected by the increasing number of problematic loans.<sup>117</sup> From the viewpoint of financial institutions, the usual suppliers of securities backed by distressed loans, securitization limits their exposure to further losses to the extent of any guarantee or credit enhancement they provide to the transaction.<sup>118</sup> At the same time, the risks and rewards of the underlying problem loans are transferred to and spread among market participants.<sup>119</sup>

From the investors' perspective, securities backed by distressed loans can provide profitable investment opportunities as long as the capital returns exceed the undertaken risks.<sup>120</sup> In a distressed loan securitization transaction, investors expect that either the asset pool or the recoveries from loan collateral can

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116. A loan is deemed distressed when the borrower's financial ability to honor its payment obligation comes into question. Common indicators of a borrower's financial difficulty include a breach of financial covenants, a payment or technical default of other debt obligations, or a trading value for their debt significantly below other debts with similar coupon and maturity features. Not all distressed debts are in default. The distressed debt of an issuer may be current on its bank loan obligations, but in technical or financial default on its other subordinated debt. However, in this situation, there is substantial near-term risk that the borrower will eventually default on its loan obligations. See Henry Albuлесcu et al., *Distressed Debts CDOs Spinning Straw into Gold*, S&P (May 7, 2001), available at <http://www.standardandpoors.com> > "fixed income" > "credit ratings criteria" [hereinafter *S&P Criteria*].

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

provide sufficient value to compensate their investment.<sup>121</sup> To attract investors with different risk appetites, an originator may structure the transaction in a way that the same asset pool to generate several classes of notes with hierarchical seniority and different credit ratings.<sup>122</sup>

In determining the proper interest rates payable to investors, the ABS credit ratings assigned by credit rating agencies are crucial. These agencies serve the public investors' information needs by inquiring and analyzing the key features of a securitization transaction.<sup>123</sup> For example, Standard & Poor's considers a number of factors in rating a distressed loan securitization transaction originated by a financial institution: (1) quantitative and qualitative characteristics of the obligor's credit worthiness; (2) recoveries; (3) quantification of liquidity needs; (4) cash flow defaults and recoveries; (5) structural considerations; (8) collateral manager capability; and (7) legal analysis.<sup>124</sup>

### *B. Feasibility of Distressed Loan Securitization*

At the heart of securitization is that asset pools must be able to generate reasonably predictable cash flows to pay ABS investors interest and principal.<sup>125</sup> Four factors are specifically important in determining the securitizability of distressed loans: (1) the nature of the obligors; (2) the recovery rates of the distressed loans; (3) the quality of the originator-servicer; and (4) the availability of liquidity facility and credit enhancement.

First, whether distressed loans are suitable for securitization heavily depends on the nature of loan obligors.<sup>126</sup> As commentators point out, the primary threats to steady ABS cash flows are the risks of obligors' slow payment or no payment.<sup>127</sup> To offset these risks, the asset pool created should satisfy three requirements: (1) the loan portfolio must consist of a sufficiently

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121. *Id.*

122. *Id.*

123. *See Rating Agency Paradox, supra* note 105, at 10.

124. *S & P Criteria, supra* note 116, at "Overview of Standard USD Poor's Methodology."

125. SCHWARCZ, *STRUCTURED FINANCE, supra* note 7, at 2-1.

126. *Id.* at 1-1

127. The slow-payment risk is that the obligor on the loans may delay in making their payments, thus creating liquidity problem for the SPV. The no-pay risk is that the obligators may default in making their payments. *Id.* at 2-2.

large number of obligors in order to allow a statistical determination of the default risk;<sup>128</sup> (2) the loan concentration ratios should be sufficiently low in order to avoid the possibility that default by a relatively small number of obligors disproportionately harms the overall portfolio performance;<sup>129</sup> (3) ideally, the loans have homogeneous contractual terms, delinquency and loss experience in order to minimize the costs incurred in obtaining and analyzing information on the portfolio. If these criteria are met, it is possible to employ an actuarial analysis on expected losses, uniform underwriting standards and servicing procedures that are satisfactory to rating agencies and investors.<sup>130</sup> These three requirements explain why the paradigmatic securitizable assets are mortgage loans, auto loans, or bank credit card receivables. When a specific asset pool fails to meet all of the requirements, success of the transaction will require using credit enhancements to mitigate the risks.<sup>131</sup>

Second, recovery records serve as a crucial performance variable in distressed loan securitization.<sup>132</sup> By definition, distressed loans already have high delinquency and default risks. In securitization of such assets, therefore, the recovery ratio becomes a more meaningful consideration than default risk.<sup>133</sup> Recoveries may come from refinancing, restructuring or liquidation.<sup>134</sup> As long as recoveries produce a cash flow with relative predictability, the securities backed by distressed loans can also receive high credit rating, which may be further improved through credit enhancement. Factors relevant to such recoveries include the characteristics of coupons, collateral type, and origination date.<sup>135</sup> For example, if the loan is collateralized by assets with high liquidity value, such as tradable securities or real property at a good location, then the recovery ratio is likely to be high.

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128. *Id.*

129. This term refers to a situation where a relatively small number of the obligors account for a disproportionately large amount of loan portfolios. *Id.* at 2-2 to 2-3.

130. Shenker & Colletta, *supra* note 90, at 1377.

131. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 2-2.

132. *S & P Criteria*, *supra* note 116, at "Recoveries."

133. *Id.*

134. *Id.*

135. *Id.*

Third, the originator-servicer (usually a financial institution) plays a key role in a distressed loan securitization.<sup>136</sup> After all, the originator is the entity responsible for creating the asset pool from a suitable portfolio.<sup>137</sup> In addition, investors also rely heavily on the originator to channel the cash flow generated from the asset pool to the SPV for interest distribution.<sup>138</sup> Furthermore, the originator often assumes the servicer's role given its experience and skills in collecting debts and enforcing creditor's rights. In the event of loan defaults, the originator should take the best course of action to maximize recoveries for the investors' benefit.<sup>139</sup> In servicing securities backed by distressed loans, the originator's main task is not one of selecting and monitoring loans that are expected to be performing.<sup>140</sup> Rather, the focus is on choosing weak loans with good recovery prospects and on actively working with the defaulted borrowers, the lending group, bankruptcy courts, and any other parties in order to generate the necessary cash flow to service the required ABS payments.<sup>141</sup> To increase its ability to better service the asset pool(s), the originator may also transfers a part of servicing function to a reliable outside specialist.<sup>142</sup>

Finally, liquidity facility and credit enhancement mechanisms are often necessary to meet cash shortfalls and to raise ABS credit rating to a desirable level. One great liquidity need stems from significant loan defaults and/or restructurings.<sup>143</sup> Defaults usually result in an immediate cessation of the borrowers' promised loan payments.<sup>144</sup> In addition, restructuring and bankruptcy by one obligor may cause a write-down or extension of an original loan contract in order to alleviate the debtor's financial burden.<sup>145</sup> When any of these events happen, it becomes less certain when obligors' repayments under loan

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136. Felson, *supra* note 99, at 603.

137. *S & P Criteria*, *supra* note 116.

138. Felson, *supra* note 99, at 603.

139. *S & P Criteria*, *supra* note 116.

140. *Id.*

141. *Id.*

142. Felson, *supra* note 99, at 604.

143. *S & P Criteria*, *supra* note 116.

144. *Id.*

145. *Id.*

contracts can be collected to service the ABSs.<sup>146</sup> Other than the liquidity problems caused by obligors, there are also cash needs to pay periodic transactional fees,<sup>147</sup> such as fees for servicer, trustee, accountants, legal experts and financial advisors.<sup>148</sup> Given the magnitude of liquidity problems in distressed loan securitization, therefore, it is necessary to create significant reserve accounts filling cash shortfalls.<sup>149</sup>

Credit enhancement mechanisms are also necessary to mitigate the problem of low repayment predictability and to raise the credit ratings of securities backed by distressed loans.<sup>150</sup> External credit enhancement can take different forms, such as a guaranty or surety bond, a bank letter of credit, an irrevocable credit line, or cash collateral account.<sup>151</sup> There are two common types of internal credit enhancement used in distressed loan securitization. One is over-collateralization, which means the anticipated cash flow from the underlying assets exceeds the scheduled principal and interest payments.<sup>152</sup> This arrangement helps to assure that a sufficient cash cushion exists to meet repayment obligations. The second one is senior-subordinate structure,<sup>153</sup> in which sophisticated investors willing to take a high level of risk would purchase subordinated securities, effectively providing another assurance for the SPV's senior securities bought by average investors.<sup>154</sup>

### C. *The RTC Securitization Program*

The first securitization of non-performing loans in the U.S. history was the "N" series program by the Resolution Trust

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146. *Id.* Additional liquidity problems can arise with revolving loans. When distressed revolving bank loans are sold to the SPV, both the right to receiving borrower payments and the obligation to fund borrower draws are transferred to securitization. However, the terms of most revolving facilities loan allow the lenders to suspend borrower draws if there is any significant deterioration or material change in the borrower's financial condition. Therefore, the corresponding liquidity needs may be less of a concern. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 2-16 to 2-17.

152. GIDDY, *supra* note 12, at 11.

153. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 2-17 to 2-18.

154. The interest rate on these subordinated securities would be higher than that on the senior securities to compensate for the greater risk. *Id.*

Corporation (“RTC”) in the early to mid 1990s.<sup>155</sup> Congress created RTC as a major effort to manage and resolve the assets of failed savings and loan associations.<sup>156</sup> In its six years of existence, the RTC resolved 747 insolvent thrifts and recovered USD395 billion of the USD456 billion in its charge.<sup>157</sup> Heralded by observers as an outstanding success, the RTC employed many innovative strategies to promptly dispose of portfolios under its mandate.<sup>158</sup> The options RTC used varied depending on the quality and nature of the assets involved. High liquid assets, such as government securities, single-family mortgage-backed bonds, and high-yield bonds were disposed of without much difficulty in the well-developed secondary markets.<sup>159</sup> For lower quality assets such as non-performing mortgages, the RTC employed three major techniques: bulk sales, auctions, and mortgage securitization.<sup>160</sup>

The RTC’s securitization model for mortgage-backed securities presented several features. First, the RTC issued securities in registered offerings.<sup>161</sup> The disclosure requirements of regis-

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155. See Jack Rodman, *Asia’s Budding Revival*, 60 MORTGAGE BANKING 3640 (2000).

156. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 501, 103 Stat. 183, 184 (codified as amended at scattered sections of 12 U.S.C.).

157. See Dean Foust, *The RTC’s Epitaph: It Worked*, BUS. WK., Jan. 15, 1996, at 29; Alvin K. Lim, *The S&L Crisis Revisited: Exporting An American Model to Resolve Thailand’s Banking Problems*, 9 DUKE J. COMP. & INT’L L. 343, 355–56 (1998).

158. See Foust, *supra* note 157. The RTC achieved impressive performances, evidencing by the fact that the taxpayers’ burden for the clean-up was only under USD145 billion, much less than many experts had predicted, the agency also received various critics. See Lim, *supra* note 157, at 355–56. However, it was charged with mismanagement, including the excessive use of expensive consultants as well as outright fraudulent billing by contractors, as well as hastily unloading its assets at bargain prices to the benefit of wealthy investors and detriment of taxpayers. See *id.* Nevertheless, “the general consensus is that the RTC was a rare example of a government agency that operated efficiently and effectively.” *Id.*

159. See Lim, *supra* note 157, at 357.

160. *Id.*

161. *Id.* at 359. The RTC initially filed a USD4 billion shelf registration with the SEC in May 1991 to securitize single and multi-family mortgage loans. It subsequently filed more registrations to accommodate additional transactions in single and multi family loans, as well as commercial mortgage loans. See also Kenneth J. Bacon, Director of RTC Office of Securitization,



tration allowed investors to access material information regarding the underlying mortgages' risks, thus increasing public interest in the issuance and resulting liquidity of the securities.<sup>162</sup> In addition, the assets underlying the securities were typically held in trusts, which further reassured investors that the asset pools would be under unitary management.<sup>163</sup> Furthermore, credit enhancements, such as reserve funds, were used to obtain sufficiently high investment ratings in order to entice institutional investors.<sup>164</sup> Finally, to handle non-residential commercial mortgages in the pool that became non-performing, a "special servicer" was established to review the cases and take all necessary measures to minimize losses.<sup>165</sup>

Under the N-series program created specifically for securitization of sub- and non-performing mortgage loans, the RTC required interested commercial mortgage bankers to align with equity investors to purchase about half of any loan portfolio, while the RTC retained the remaining portion as a passive partner.<sup>166</sup> The first deal of N series, N-1, closed in December 1992.<sup>167</sup> This deal acquired USD350 million in book value of non- and sub-performing loans from the RTC.<sup>168</sup> The RTC, as a partner in the fund, leveraged the portfolio with USD110 million of debt raised by Lehman Brothers, and then sold a 50% equity interest in the remaining cash flows to Bankers Trust and Soros Realty for an undisclosed sum.<sup>169</sup> The RTC's NPL securitization program was successful partially because the agency worked closely with the private sector in market development.<sup>170</sup> Usually, private institutional investors participated

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*Securitization at the RTC*, NAT'L MORTGAGE NEWS, Apr. 12, 1993, at 4, available at LEXIS News.

162. See Lim, *supra* note 157, at 359.

163. *Id.*

164. *Id.* Reserve fund levels were approximately four to seven times the expected losses on the total amount of assets the RTC securitized. The reserve funds were held by a trust and funded from bond proceeds. Bacon, *supra* note 161.

165. See Lim, *supra* note 157, at 360.

166. *Commercial MBs Can Service RTC CRE*, NAT'L MORTGAGE NEWS, March 1, 1993, at 13, available at LEXIS News.

167. Marlene Givant Star, *RTC Courts Pension Fund Assets*, PENSIONS & INVESTMENTS, March 22, 1993, at 35, available at LEXIS News.

168. *Id.*

169. *Id.*

170. See Bacon, *supra* note 161.

in the transactions in teams composed of asset managers, distressed loan servicers, and underwriters. These teams could then capitalize on their expertise in NPLs and structured finance, and make use of their access to capital markets.

#### V. SECURITIZATION DEVELOPMENT IN EAST ASIA

This Part examines the securitization experience of Japan, Korea and Taiwan, with an emphasis on their legal and regulatory development facilitating local market securitization.

As a sophisticated financial innovation, securitization has witnessed phenomenal successes in the U.S. and United Kingdom. This phenomenon perhaps surprises no one as these two countries enjoy the benefits that come along with a flexible common law system and highly developed financial markets. While many other countries also seek to develop similar programs in their own markets,<sup>171</sup> they come to realize the necessity and importance of establishing not only supportive capital markets but also adequate legal and regulatory infrastructures.<sup>172</sup>

To many Asian countries, their civil code systems present obstacles for carrying out securitization comprehensively. One commentator remarks on this difficulty:

[T]raditional asset securitization structures cannot simply be “parachuted” into individual financial systems (especially those of emerging market economies with a civil law tradition) and expected to fulfill the sorts of functions for which they are so useful in the United States and the United Kingdom.<sup>173</sup>

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171. For example, France and Spain have successfully completed securitization transactions, Germany and Italy have passed legislation to promote securitization. See generally, ASSET-BACKED SECURITIZATION IN EUROPE (Theodor Baums & Eddy Wymeersch eds., 1996).

172. See Douglas Arner, *Emerging Market Economies And Government Promotion of Securitization*, 12 DUKE J. COMP. & INT'L L. 505, 506 (2002) (outlining for an emerging economy the requisite capital market and legal factors necessary for mortgage securitization).

173. Arner listed the following purposes that securitization may serve in the developed financial markets of the U.S. and U.K.: (1) supporting public policy objectives such as broad home ownership and the development of financial markets (especially capital and mortgage markets); (2) addressing regulatory requirements for financial institutions, especially capital adequacy and lending limit requirements applicable to banks; (3) transferring risk, especially in the context of non-performing assets and portfolio diversification; and (4) providing finance. See *id.* at 505. In addition, Feldkamp argued that properly

Nonetheless, undertaking an asset securitization transaction in any given jurisdiction serves as a useful "stress test" of the limits in that specific jurisdiction, especially in respect to legal impediments.<sup>174</sup>

Although the inflexibility of civil legal systems makes it difficult to accommodate various securitization structures,<sup>175</sup> East Asia's great need for new capitals, especially after the financial crisis of late 1990s, has spurred exportation of this financial technology into the region.<sup>176</sup> With governmental support, several Asian economies have actively modified their individual legal and regulatory frameworks by implementing new legislation.<sup>177</sup>

Japan is the first Asian country that experimented with securitization. In the late 1980s and early 1990s, several Japanese government charged committees and organizations started to explore this financial tool.<sup>178</sup> In 1993, the Japanese Diet (the parliament) enacted the Law Regarding Regulation of the Business Concerning Specified Claims ("Specified Claims Law"), which permitted limited securitization of leases and credit card claims.<sup>179</sup> This legislation provided the impetus for the first securitizations backed by assets, such as auto loans and industrial and computer lease receivables.<sup>180</sup> In 1995, the Ministry of Finance proposed a liberalization of the financial markets to permit financial institutions and certain credit corporations to issue ABSs through domestic special purpose corporations.<sup>181</sup> The Japanese "Big Bang" initiated in 1996 set prompt resolu-

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implemented securitization could prevent or cure "liquidity traps," the "ultimate bad consequence of flawed economic and financial management policies" in the U.S. See Feldkamp, *supra* note 99, at 1.

174. Arner, *supra* note 173, at 506.

175. Kevin T.S. Kong, *Prospects For Asset Securitization Within China's Legal Framework: the Two-Tiered Model*, 32 CORNELL INT'L L.J. 237, 244 (1998).

176. *Id.*

177. For example, Indonesia enacted the Mortgage on Land and Land-Related Objects Law to facilitate secured lending based on land assets. Thailand introduced implementing legislation to create insolvency and trustee laws similar to the U.S. legal structure. *Id.*

178. Felson, *supra* note 99, at 591.

179. *Id.*

180. *Id.*

181. *Id.*

tion of the NPLs as a top priority for banking liberalization.<sup>182</sup> In a landmark transaction of 1999, Morgan Stanley Dean Witter sold the first securities backed by Japanese NPLs on a mix consisting of office, retail and apartment buildings.<sup>183</sup>

The Japanese legal and regulatory framework relevant to securitization went through considerable changes in the 1990s.<sup>184</sup> The developments in four legal areas are most significant. First, the burdensome perfection procedure imposed by the Japanese Civil Code<sup>185</sup> was streamlined through the passage of so called MITI Securitization Law of 1993<sup>186</sup> and more significantly the 1998 Perfection law.<sup>187</sup> Under the new perfection system, assignments of large numbers of financial assets can be perfected easily through a one-time filing.<sup>188</sup> Second, the Law

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182. *Id.*

183. Rodman, *supra* note 155.

184. For a discussion on the legal obstacles to securitization that Japan faced before the major framework modification was completed, see Hideki Kanda, *Securitization in Japan*, 8 DUKE J. COMP. & INT'L L. 359 (1998) (identifying three major obstacles: first, the compliance with the perfection requirements in connection with an asset transfer was costly and cumbersome; second, Japanese corporate law made it expensive to set up a special purpose entity; third, the regulatory structure of securities was complex and inflexible due to the long history of jurisdictional struggles among ministries involved).

185. Under the article 467 of Japanese Civil Code, to perfect the assignment of a contractual right, including receivables with respect to interested third parties, the assignor must either deliver proper notice or obtain necessary consent. In either case, the assignor is required to ensure that the relevant documents bear officially certified dates. See Masaru Ono, *Unique Aspects of Japanese Securitization Relating To The Assignment of Financial Assets*, 12 DUKE J. COMP. & INT'L L. 469, 472 (2002). See also, Yoshiki Shimada & Shinji Itoh, *Japanese Asset Securitization: A Guide For Practitioners*, 38 HARV. INT'L L. J. 171, 179-180 (1997).

186. TOKUTEI SAIKENTO NI KAKARU JIGYO NO KISEI NI KANSURU HORITSU [Law concerning the restrictions of business relating to specified claims, etc.], Law No. 77 of 1992. This law is commonly named after its main sponsor, the Ministry of International Trade and Industry ("MITI"). This law covers only specific types of financial assets, mainly auto loans and lease receivables. It is less often used since the passage of the Perfection Law.

187. SAIKEN JOTO NO TAIKO YOKEN NI KANSURU MINPO NO TOKUREITO NI KANSURU HORITSU [Law prescribing exceptions, etc., to the civil code requirements for setting up against a third party to an assignment of claims], Law No. 104 of 1998. This law has a broader coverage. It allows general companies to perfect the assignment of monetary claims in relation to third parties through filing a simple electronic registration with the Legal Affairs Office of the Japanese government. See Ono, *supra* note 184, at 472.

188. *Id.*

Concerning the Securitization of Specified Assets by Special Purpose Companies ("SPC law") was passed and subsequently amended to reduce the cost of the establishment and operation of special purpose vehicles.<sup>189</sup> Third, in 1998, Japan amended the Foreign Exchange and Foreign Trade Law to facilitate cross-border transactions. The amended law eliminated licensing and prior notification requirements previously imposed on any transfer of receivables between Japanese residents and foreigners.<sup>190</sup> Finally, Japan enacted a new "servicer" statute to allow corporations to engage in the business of servicing NPLs originated by financial institutions.<sup>191</sup> This enactment has invited major foreign players to establish special-purpose corporations to service NPLs, providing comfort among the international investors interested in acquiring such assets in Japan.<sup>192</sup>

Securitization also made substantial inroads in other East Asian countries in the late 1990s when the region was struggling with the aftermath of a major economic and financial breakdown. In Korea, before the Act on Asset-backed Securitization ("Korean ABS Act") was enacted in 1998, securitization was difficult, if not impossible.<sup>193</sup> The Korean ABS Act became the cornerstone of the rapidly developing securitization in Korea.<sup>194</sup> A major purpose of this act was to improve the soundness of financial institutions.<sup>195</sup> This act greatly facilitated Ko-

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189. The SPC law became effective on September 1, 1998 and was amended in 2000. Among other things, the amendment reduced the SPC's minimum capital, registration and license tax and the real property acquisition tax. The new law also broadened the scope of specific assets that may be securitized by an SPC to include general proprietary rights, in addition to loans extended by financial institutions, nominative monetary credits, real estate and beneficial interest of the trust holding such assets. See *Japan: Amendment to Promote Securitization*, 19 INT'L FIN. L. REV. 48 (2000).

190. *Id.*

191. See Yoshiki Shimad & Togo Dowaki, *Japan*, in 17 INT'L FIN. L. REV. 40 (1998).

192. Rodman, *supra* note 155.

193. Sean Bulmer & Hyoung Don Kim, *Korea*, in SECURITIZATION YEARBOOK 2000 28 (supplement to INT'L. FIN. L. REV., Oct. 2000).

194. *Id.*

195. The Act on Asset Backed Securitization, art.1 [hereinafter Korean ABS Act].

rea's NPL resolution and contributed to the successful restructuring of the country's financial system.<sup>196</sup>

The Korean ABS Act provides for the establishment of a bankruptcy-remote special purpose company ("SPC")<sup>197</sup> and the appointment of a qualified service provider to manage the assets.<sup>198</sup> It also sets forth certain conditions, which if satisfied assure a transfer of assets to be a true sale rather than a secured financing.<sup>199</sup> The Act further requires registration of a securitization plan, which contains certain information regarding the transferred assets, originator and securities issued.<sup>200</sup> The registration of assets transfer can be accomplished through a filing with the Financial Supervisory Committee.<sup>201</sup> In addition, securitization enjoys certain tax benefits, including a 50 percent reduction in capital gains taxes for the sale of real properties by the SPC, and an exemption of registration and acquisition taxes on real properties acquired by the SPC within a certain period of time.<sup>202</sup>

The Korea Asset Management Corporation ("Kamco"), a government NPL resolution agency,<sup>203</sup> has achieved impressive per-

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196. South Korea emerged as the star performer among the Asian economies in financial reform. It leads the way of restoring banking industry to health. *Asian Banking 2000 Review*, *supra* note 26, at 45.

197. Korean ABS Act, ch. 3.

198. *Id.* art. 11.

199. *Id.* art. 13. It is rather special that this act details the specifics of true sale instead of leaving it to the discretion of the courts. See Jong-Goo Yi, *Trends and Issues in Securitization in Korea*, INT'L FIN. L. REV. 2425 (Apr. 1 2001), available at 2001 WL 15390492.

200. Korean ABS Act, arts. 3–4.

201. On completion of the transfer registration, the transfer of receivables will be deemed to have been perfected against third parties, which obviates the need to complete the normal perfection steps such as sending of notices with a fixed date stamp. If receivables are secured by mortgages, on registration of transfer of receivables with the FSC, the mortgages are deemed to have been transferred to the SPC. Therefore, the normal steps to register the transfer of mortgages with the relevant real property registration office are not necessary. *Id.* arts. 6–8.

202. See Yi, *supra* note 199.

203. Kamco is the only institution in Korea charged with this mandate. This mission is stated under the government Act on the Efficient Disposal of Bad Assets of Financial Institutions. Currently, 38% of Kamco's shares are directly owned by the Korean government, another 31% indirectly owned by the government through the Korea Development Bank, and the rest is owned by 24 Korean financial institutions. Of the NPLs acquired by Kamco, 63.19% were from commercial banks, 24.81% from investment trust companies, 7.97%

formance in utilizing securitization to resolve NPLs. From 1999 to 2001, Kamco successfully securitized USD5.9 billion of NPLs acquired from financial institutions.<sup>204</sup> Kamco made its first domestic public offering of NPL backed securities worth USD271 in June 1999.<sup>205</sup> Samsung Securities and Hyundai Securities bought the bonds and auctioned them off to local investors.<sup>206</sup> Kamco's first international NPL securitization was accomplished in July 2000.<sup>207</sup> A dual SPV structure accomplished this transaction.<sup>208</sup> A Korean SPV sold a senior note backed by a NPL portfolio denominated in U.S. dollars and Japanese yen to a Cayman SPV.<sup>209</sup> Two credit enhancements were used for the Korean senior note: subordinated notes and irrevocable credit facility that the Korean Development Bank provided.<sup>210</sup> The Cayman SPV then issued USD367,000,000 floating rate notes due in 2009, secured by the issuer's interest in the Korean SPV senior note.<sup>211</sup> The Cayman SPV senior notes were rated at BBB and Baa2 by Fitch and Moody's respectively, and listed on the Luxemburg Stock Exchange.<sup>212</sup> The notes were then offered to qualified institutional buyers in the U.S. pursuant to Rule 144(a).<sup>213</sup>

Taiwan passed its Financial Assets Securitization Statute in 2002.<sup>214</sup> Modeled on the Japanese civil law approach, this legislation provides for Special Purpose Trusts ("SPTs") to securitize assets and issue beneficiary certificates backed by those as-

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from insurance companies and 3.61% from merchant banks. See *FQA*, at <http://www.kamco.or.kr/eng/faq/faq1.htm> (last visited Feb. 27, 2003).

204. *New Tack Eyed for Collection Agency*, NIKKEI WEEKLY (July 9, 2001), available at LEXIS News.

205. *Kamco "MIRAE" Bond 99-1*, at <http://www.kamco.or.kr/eng/area/mirae/mirea99-1.htm> (last visited Oct. 17, 2002) [hereinafter *Kamco "MIRAE" Bond 99-1*].

206. *Id.*

207. Sean Bulmer & Hyoung Don Kim, *Kamco NPL Securitization*, in SECURITIZATION YEARBOOK 2000 28, 29 (supplement to INT'L FIN. L. REV. (2000)) [hereinafter *Kamco NPL Securitization*].

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*

214. Karen Richardson, *Taiwan's Tough Stance on Banks Lures Investors*, WALL ST. J., Dec. 18, 2002, at C14.

sets.<sup>215</sup> It also sets out the types of financial assets that may be securitized.<sup>216</sup> The act permits financial institutions to pool home mortgages, credit-card receivables, or corporate loans — including non-performing loans — and then issue new debts backed by these assets.<sup>217</sup> In addition, borrowing the U.S. concept of “Ginnie Mae,” the act allows Taiwanese government and financial institutions to establish a fund to promote securitization and guarantee creditworthiness.<sup>218</sup> Significantly, financial analysts view this legislation as a major component of Taiwan’s comprehensive program to clean up its NPL laden banking industry.<sup>219</sup> Experience in several other Asian countries, including Thailand and the Philippines,<sup>220</sup> also demonstrated that during the time of financial turmoil, there tended to be a great demand for the restructuring of financial institutions with a large volume of non-performing assets.<sup>221</sup> Notably, the need to resolve NPLs, a prevalent problem in the region, served as a catalyst for securitization in East Asia.

## VI. NPL SECURITIZATION IN CHINA: THE MARKET CONDITIONS

When acceded to the WTO in December 2001, China undertook to open its entire financial sector to foreign competition after five years. As time quickly goes by, the Chinese government sees the increasing exigency of overhauling its insolvent banking system. Promptly disposing of the daunting NPLs, therefore, tops China’s financial restructuring agenda. Because of the U.S. and other Asian countries’ successful experience, securitization began to attract attention in China as an alternative NPL resolution. The PBoC, a major Chinese financial regu-

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215. Qi Lin International Law Offices, *Securitization Law Nears Passage* (Sept. 2001), available at [http://www.securitization.net/pdf/qilin\\_cm\\_0901.pdf](http://www.securitization.net/pdf/qilin_cm_0901.pdf).

216. Taiwan’ NPL ratio is estimated to range from 6.5 to 15% of all loans. Neil Campbell et al., *Securitisaiton Comes to Taiwan* (Oct. 2001), available at [http://www.securitization.net/pdf/qilin\\_sectai\\_1001.pdf](http://www.securitization.net/pdf/qilin_sectai_1001.pdf).

217. Richardson, *supra* note 214.

218. Qi Lin, *supra* note 215.

219. *Id.* See also Campbell, *supra* note 216.

220. Richardson, *supra* note 214.

221. See Yi, *supra* note 199. In fact, Japan has recently realized that it has been slow in securitizing the distressed loans taken over by the Resolution and Collection Corporation, and that it should learn from the successful experience of the Korea Asset Management Corporation. *New Tack Eyed for Collection Agency*, NIKKEI WEEKLY, July 9, 2001, available at LEXIS News.



lator, has indicated its support for such an experiment.<sup>222</sup> Financial institutions, especially the AMCs mandated with NPL disposition, have been actively exploring this new option.<sup>223</sup>

#### A. Supply of NPL Securitization

The supply of NPL securitization in China can be understood from the four feasibility factors identified in Part IV.<sup>224</sup> The first factor affecting asset pool creation is the nature of obligors. Ideally, the underlying portfolio should feature with a statistically large number of obligors, low loan concentration ratios, and standardized or similar loan contractual terms.<sup>225</sup> In reality, however, the Chinese state banks have extended four fifths of their lending to SOEs, particularly favoring a targeted group consisting of the biggest ones, which the government deemed as pillars of the state sector.<sup>226</sup> Furthermore, because bank lending oftentimes provided the main source of working capitals for SOEs, loan agreements varied in their terms, depending upon the borrowers' business and financial conditions.<sup>227</sup> Unfortunately, a large number of SOEs do not generate enough operating revenues even before interest expenses were paid.<sup>228</sup> Many of them have no viable prospect of becoming profitable. They have not been liquidated due to the governmental concern that

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222. During the "China Development Summit Forum" held on March 25, 2001 in Beijing, Dai Xianglong, governor the Chinese Central Bank PBoC, stated that China would study the successful experiences of international asset management companies and experiment assets securitization as a way to dispose of NPLs. Dai also emphasized the possibility of using securitization as a means to introduce international capital and expertise into Chinese banking sector. See *Zhengquanhua: Huajie Buliang Zichan de Youxiao Tujing* (Securitization: An Effective Approach of Resolving NPLs), JINRONG LILUN YU SHIJIAN (FIN. THEORIES AND PRAC.) (Beijing, 2001).

223. Our analysis of the NPL securitization market below focuses on the portfolios transferred from the state banks to the AMCs for the reason that the AMCs are specifically set up by the government to deal with NPL resolution. Major references are made to the practices of Huarong, one of the biggest and most adventuring AMCs in China.

224. See *infra* Part IV.

225. See *infra* footnotes 126–154 and accompanying text.

226. *Casino Capital*, *supra* note 1, at 11.

227. See Dan Huang, *Woguo Tuixing Zichan Zhengquanhua de Zhang'ai Fenxi* (An analysis on the Obstacles to Asset Securitization in China) at 1 (on file with the author).

228. See *Pitfalls Ahead*, *supra* note 74.

an aggressive reform plan would produce vast social implications and even unrest.<sup>229</sup>

The foregoing analysis of the first factor establishes that a vast majority of NPLs under the Chinese AMC's management is not suitable for securitization. However, it is not true that NPLs securitization is completely impossible. An inquiry under the second factor, i.e. the recovery ratios, shows that among the massive portfolios of Chinese NPLs, three groups of NPLs seem to be potentially securitizable.

The first group is the non-performing commercial mortgages extended in the mid 1990s during economic overheating.<sup>230</sup> This type of NPL, although accounting for only a small percentage of the overall Chinese NPLs, is still sizable in absolute dollar amounts.<sup>231</sup> Recovering certain portion of such NPLs' value is viable given the rapid economic growth seen in the major Chinese cities, the locations of many the real estate projects involved in NPLs.<sup>232</sup>

In addition, non-performing corporate loans secured by land use rights or other real estate collateral are also potential securitization assets. However, cash flow generated through foreclosure and liquidation of NPL collateral must be reasonably predictable to support the ABS repayments.<sup>233</sup> This would rest on the enforceability of the AMC's creditor rights and a functioning liquidation market.<sup>234</sup> However, China's current conditions with respect to both factors are yet to be further improved.

The last group of securitizable NPLs originates from loans rendered to SOEs with whom the AMC's are able to work out

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229. See *Corporate/Debt Restructuring: Japan, The Hong Kong SAR & The People's Republic of China: A Roundtable Discussion*, 10 AM. BANKR. INST. L. REV. 1, 23 (2002) [hereinafter *Roundtable Discussion*]. See generally, LARDY, *supra* note 22, ch. 2 (*The State-Owned Enterprise Problem*).

230. See *supra* notes 46–47 and accompanying text.

231. Interview with Xiaobo Wang, General Manager of Huarong Research Department, in Beijing, China, (Jan. 9, 2003) [hereinafter Interview with Wang]. No published statistics on this category of NPLs are currently available.

232. Cf. Felson, *supra* note 99, at 609 (arguing that *jusen* (Japanese consumer mortgage loans) securitization could provide investors with a profitable opportunity when the real estate appreciates as a result of development programs and an overall growth in the Japanese economy).

233. See Xiaobo Wang, *Buliang Zichan Ye Keyi Zhengquanhua* (Non-Performing Loans Can Also be Securitized) (on file with the author).

234. Interview with Wang, *supra* note 231.

reliable repayment schedules. In fact, Kamco, the Korean counterpart of the Chinese AMC's, has successfully securitized certain distressed corporate loans transferred from financial institutions.<sup>235</sup> Significantly, Kamco securitized only "restructured corporate loans," i.e. loans that have obtained court approvals of restructuring as part of corporate re-organization or composition proceeding regardless of security existence.<sup>236</sup> The borrowers were private companies considered operationally viable with only temporary liquidity problems.<sup>237</sup> The asset pools, therefore, could generate predictable repayments based on court sanctioned restructuring schedules.<sup>238</sup> Among the Chinese AMC's debtor SOEs, there exist a certain number of companies that have viable business prospect but incurred excessive debts. These companies are potentially able to pay off a portion, but not the whole, of their bank loans.<sup>239</sup> Effective debt restructuring with these SOE debtors, therefore, would recover a fraction of the NPL book value.<sup>240</sup> In fact, the Chinese government has provided the AMC's with an authority to partially forgive certain SOE's debts and then work out the balance in new payment schedules.<sup>241</sup> For example, among Huarong's NPL recoveries, over 80% were accomplished through debt restructuring, with less than 20% stemming from liquidation.<sup>242</sup> To support securitization, however, the repayment stream under debt restructuring must be reasonably predictable. Absent the court

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235. See Kamco "MIRAE" Bond 99-1, *supra* note 205.

236. Therefore, when Kamco initially purchased these loans, the original lenders were not entitled to declare default or execute their claims through the foreclosure. This was due to the current and existing repayments of the loans according to the rescheduled payment schedules. Thus, in valuing the restructured loans, more emphasis has been given to the credit standing of the borrowers. *Id.*

237. *Id.*

238. *Id.* In addition, when purchasing the NPLs from the Korean commercial banks Kamco retains a put option, which allows Kamco to sell back the NPLs to the relevant banks on the occurrence of certain events such as payment default continuing for six months. *Id.*

239. Kaisheng Yang, Restructuring and Disposing of China's Financial Non-Performing Assets — A New Investment Trend in China, Address at Asia Society's Conference "Investing in China's Financial Market" (May, 2002) (on file with the author) [hereinafter Yang Speech].

240. *Id.*

241. The banks are however not permitted to reach such partial debt forgiveness agreements with their SOE debtors. *Id.*

242. *Id.*

sanction and monitoring that were available to Kamco, the Chinese AMC's will have to rely on the not very effective non-judicial methods to enforce their restructured payment plans.

The foregoing discussion indicates that the Chinese AMC's may create asset pools consisting of certain securitizable NPLs.<sup>243</sup> In order to understand the technical aspects of securitization one must also consider the third and fourth feasibility elements.

The quality of servicer cannot be overestimated. To make a NPL securitization plan work, the originator-servicer, which in this note's analysis would be one of the Chinese AMC's, must recover predictable cash flows either by actively working with the obligors, or by liquidating foreclosed loan collateral. The AMC's can be expected to well perform the originator-servicer functions given their full resolution power and expertise in debt collection and workout. In addition, the AMC's can further enhance their capability through strategic alliance with experienced international counterparts.<sup>244</sup>

The success of NPL securitization also requires the availability of liquidity arrangements and credit enhancements. Given the low predictability of NPL repayment cash flows and substantial liquidity risks, significant reserve accounts are usually indispensable to fill the cash shortfalls.<sup>245</sup> Furthermore, credit enhancements are also necessary in order to provide structural protection. In the case of Chinese NPL securitization, to raise the ABS credit rating to above investment grade, it is desirable

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243. Huarong seems to have completed its design of a pilot asset backed securitization scheme and the establishment of asset pools. It has submitted this plan to relevant financial regulators. CHINA HUARONG ASSET MANAGEMENT CORPORATION, OVERVIEW 2001, at 15 (on file with author). In fact, Huarong's first international NPL auction provides a good example of portfolio selection for the purpose of structuring a particular transaction. About 60% of the assets underlying the sold NPLs are in SOEs, with the remainder to commercial property, industrial parks, hotels, residential precincts, and a free trade zone. See Kynge, *supra* note 87.

244. For example, on April 26, 2001, Huarong entered with Kamco a memorandum inviting the latter to work as its advisor in securitization, and to assist Huarong select portfolios and design securities structure. *Huarong Invites Foreign Advisor for Asset-Based Securitization*, XIN HUA, April 26, 2001, available at LEXIS News.

245. Wang, *supra* note 233, at 3.

for the AMCs to provide guarantees and to use senior/subordinated structures.<sup>246</sup>

*B. Demands for NPL Securitization*

The demand for NPLs securitization cannot be analyzed without first understanding the general conditions of China's capital markets. Although the markets have achieved remarkable growth, they still have a long way to go before reaching a more mature stage. The following discussion highlights a few prominent market features.

First, expansions in primary equity market and that of primary debt market are not balanced, with the former far outstripping the latter. China's debt market mainly consists of treasury bonds.<sup>247</sup> In 1987, the Ministry of Finance issued the nation's first treasury bonds, and by 1998 total Treasury issues rose to about USD80 billion.<sup>248</sup> This increase resulted from the Chinese government's growing reliance on treasury issues to finance its fiscal deficits.<sup>249</sup> In contrast, the equity market has experienced a much more dramatic growth. China did not have a stock market until 1990, but now more than 1,200 stocks are listed on the Shanghai and Shenzhen stock exchanges, with a market capitalization of around USD500 billion, second in Asia only to Japan.<sup>250</sup> In addition, Chinese companies make up 35% of Hong Kong's stock market capitalization, against only 7% in 1995.<sup>251</sup>

In addition, the secondary market activities are significantly speculative. Price/earning ratios in China's stock market are not supported by fundamentals.<sup>252</sup> Individual investors, rather than institutional investors, dominate the nation's stock mar-

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246. *Id.*

247. Bob Yau-Ching Chan, *The Mortgage-Backed Securities Market in the People's Republic of China*, in MORTGAGE-BACKED SECURITIES MARKET IN ASIA 68-74 (1999), available at [http://www.adb.org/Documents/Books/Mortgage\\_Backed\\_Securities\\_Markets](http://www.adb.org/Documents/Books/Mortgage_Backed_Securities_Markets).

248. ERNST & YOUNG REPORT, *supra* note 25, at 35.

249. See Chan, *supra* note 247, at 247.

250. *Casino Capital*, *supra* note 1, at 10.

251. *Id.*

252. Chan, *supra* note 247, at 68.

ket.<sup>253</sup> These investors trade frequently on rumors, causing high market volatility.<sup>254</sup> In the secondary bond market institutional investors are the main players. They trade in large volumes but usually concentrate on a particular issue, and therefore making prices quite volatile.<sup>255</sup>

Furthermore, the access to capital markets is highly regulated. Under the current Company Law companies eligible for entering domestic bond market are only those which have generate profits in the past three consecutive years and where the average profits generated by such companies during such three-year period are enough to repay the companies' one year interest on the bonds to be issued.<sup>256</sup> In fact, the PBoC approved few corporate bonds were approved in recent years.<sup>257</sup> Similarly, new share listings on the stock market are subject to tight restrictions by the China Securities Regulatory Commission. The CSRC has been functioning as the "country's chief allocator of equity market," giving favor almost exclusively to SOEs.<sup>258</sup>

Finally, China's capital markets are still largely closed to foreign investors. Until very recently, the only onshore market available to foreigners was the foreign currency denominated B-share market, which is very small in capitalization (about 3% of that of the RMB denominated A-share market), and thinly traded.<sup>259</sup> With China's WTO admission, rules restricting foreign investment in domestic markets are being gradually eased. A major progress in market open-up was achieved in the end of year 2002, when the CSRC and PBoC jointly promulgated a new regulation allowing "qualified foreign institutional inves-

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253. There are about 66 million individual investors in the Chinese stock market, with 100-odd brokers, and 15 fund-management companies serving them. *Casino Capital*, *supra* note 1, at 10.

254. Chan, *supra* note 247, at 68.

255. *Id.*

256. ZHONGHUA RENMIN GONGHEGUO GONGSI FA (Company Law of the People's Republic of China) art. 159, *translated in* LEGISLATIVE AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONGRESS, THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1993, at 269-318 (1995).

257. Chan, *supra* note 247, at 69.

258. *Casino Capital*, *supra* note 1, at 11. S&P counts thirty-five "private" listed companies in China, but points out that local governments and even the military are in fact in control of a good number of them. *Id.*

259. *See* Ma, *supra* note 63.

tors" ("QFIIs") to invest in domestic equity and bond markets.<sup>260</sup> This partial market liberalization offers new opportunities for foreign investors to tap China's ever-growing domestic markets. However, due to the strict curbs on the amount of money QFIIs may invest and the length of time they can take the money out of China, so far only a handful of foreign financial institutions have expressed interest in apply for a QFII license.<sup>261</sup>

The foregoing overview of China's current capital markets demonstrates that much remains to be done to increase both market breadth and depth. Because of the novelty and complexity of securitization itself and the exotic nature of NPL securitization, there is a general lack of knowledge about the securitization concept and relevant principles. It is, therefore, not surprising to expect that the demand for NPL backed securities will be very limited. The participants in this market are likely to be confined to institutional investors, which in the domestic markets currently include commercial banks, insurance companies, pension funds, and fund management companies.<sup>262</sup> However, even the demand of these domestic institutional investors will be relatively small due to the few numbers of institutional players and their capital constraints.<sup>263</sup> In addition, many of these institutional investors are currently subject to strict limitations on their investment scope and can only invest in low-risk instruments, such as treasury bonds.<sup>264</sup> Another possibility of demand for the Chinese NPLs comes from outside of the country. Recently, some major international investors have exhibited a rising interest in the Asian NPL market.<sup>265</sup> These large global players have been quite successful in countries such as Japan, Korea and Thailand.<sup>266</sup> They now seem to be willing to shift part of their investment in the budding Chinese

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260. Provisional Measures on the Administration of Qualified Foreign Institutional Investors Investing in Domestic Securities (promulgated by CSRC & PBoC, Nov. 5, 2002), available at <http://www.isinolaw.com>.

261. See *China Limits Program on Foreign Investment*, ASIAN WALL ST. J., Dec. 2, 2002, at M2.

262. See Huang, *supra* note 227, at 2.

263. *Id.*

264. See *China State Banks to Receive Extra Help On Bad Loans*, CHINA DAILY, May 2, 1999, available at LEXIS News.

265. See Richardson, *supra* note 214.

266. *Id.*

NPL market.<sup>267</sup> However, as discussed below, international investors still hesitate to allot large amounts of money in the Chinese NPL market, mainly due to their concern with country's unsophisticated and opaque regulatory regime.

## VII. NPL SECURITIZATION IN CHINA: LEGAL AND REGULATORY FRAMEWORK

This Part first outlines the existing legal and regulatory framework relevant to securitization, including laws governing the areas of company, trust, contract, secured transaction, and bankruptcy. It then identifies the current legal obstacles or legislative gaps impeding NPL securitization. In addition, this Part suggests enactment of special legislation to facilitate securitization.

China's legal system does not specifically provide for asset securitization as a financial technique. However, Chinese companies have already successfully completed a few international securitization transactions, which involved mainly future receivable cash flows of infrastructure projects<sup>268</sup> as well as future shipping receivables.<sup>269</sup> The following discussion outlines the legal framework within which a securitization transaction may be structured.

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267. See *China Seeks Foreign Capital To Help Manage Domestic NPAs*, ASIA PULSE, Jan. 2, 2003, available at LEXIS news (pointing out that regardless of their sizes, international funds begin to see a big potential for profits in China's NPL market). In addition to Huarong's recently approved international auction, China Construction Bank is also seeking governmental approval to form a joint venture with Morgan Stanley to resolve bad assets with a book value of about USD483 million. *China Bank Seeks Aid Abroad*, ASIAN WALL ST. J., Jan. 10-12, 2003, at M3.

268. For example, in August 1996, Zhuhai Express Way Company, acting as both originator and issuer, successfully completed a USD200 million bond offering. The bond placement was secured by fees the Zhuhai municipal government collected from toll roads, bridges, and tunnels, as well annual vehicle registration fees. See *Banks See ABS As New Finance Tool*, CHINA DAILY, March 3, 1998, at 6.

269. In April 1997, China Ocean Shipping Company, a state-owned shipping company, successfully securitized its future shipping revenues from its U.S. and European business. Kong, *supra* note 175, at 240.



*A. Establishment of Domestic SPVs*

Currently, Chinese law does not allow the establishment of a special purpose corporation used in securitization transactions of many other jurisdictions. The law presently permits Chinese companies only to conduct their businesses within the scope approved by the State Administration of Industry and Commerce ("SAIC").<sup>270</sup> This strict *ultra vires* restriction raises difficulties in establishing an SPC within China.<sup>271</sup> Given that SPC's purchase and sale of receivables are likely to be deemed as financial services, SAIC will unlikely to issue a business license to an SPC, which usually has thin capital.<sup>272</sup>

However, the 2001 enactment of Trust Law<sup>273</sup> makes it possible to use a special purpose trust to carry out securitization. Although passing the Trust Law is a major legislative achievement, the "trust" concept is still new to China, as is to many other civil law countries.<sup>274</sup> Therefore, it remains to be seen how the law will be applied and interpreted in the context of asset securitization. For example, one issue would be whether the beneficiary certificates issued by SPTs are considered securities.<sup>275</sup>

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270. See Jonathan Zhifeng Zhou, *Launch of the Securitization Market in the PRC? Still a Long Way to Go*, in SECURITIZATION YEARBOOK 2000 18 (supplement to INT. FIN. L. REV., Oct. 2000). See also, Gao Peiji and Paul Kruger, *China Faces Up to the New Challenges of Securitization*, 19 INT'L FIN. L. REV. 29 (2000).

271. See Zhou, *supra* note 270.

272. *Id.*

273. ZHONGHUA REMIN GONGHEGUO XINTUO FA (Trust Law of the People's Republic of China), 9<sup>TH</sup> NAT'L PEOPLE'S CONG., 21<sup>ST</sup> SESS., STANDING COMM. (April 28, 2001), available at <http://www.isinolaw.com>. The Trust Law became effective on October 1, 2001.

274. See Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *New Developments in Structured Finance*, 56 BUS. LAW. 95, 128-129 (2000). [hereinafter *New Developments*].

275. Currently, China's Securities Law does not provide for ABS in the definition of securities. Cf. *Securitization Law Nears Passage*, *supra* note 215 (stating that under Taiwan's Financial Assets Securitization Statute beneficiary certificates issued by SPTs are classified as securities unless the Ministry of Finance determines them to be short-term bills).

### B. *Transfer of Receivables*

Articles 79 to 81 of the new Contract Law effective on October 1, 1999 deal with transfer of receivables.<sup>276</sup> Under the new law, a creditor may, subject to limited exceptions, assign its contractual rights to a third party by serving a notice to the debtor of such an assignment without first obtaining consent from the debtor.<sup>277</sup> This legal allowance greatly facilitates a receivable transfer, which is a usual step in a securitization transaction.<sup>278</sup> Such assignment, however, must be approved or registered in accordance with any legal or regulatory relevant provisions if so required thereunder.<sup>279</sup> This requirement is significant to prospective NPL securitization, in which transfer of state-owned assets are most likely to be involved. Since changes in ownership of state assets and valuations thus involved are subject to complicated regulatory regime, NPL securitization may very well require special approval by relevant agencies.<sup>280</sup>

### C. *Secured Credit Law*

China's Security Law passed in 1995 recognizes five types of security: guarantee, mortgage, pledge, lien, and deposit.<sup>281</sup> The law provides that buildings, land use rights, and movable property such as machinery may be mortgaged.<sup>282</sup> The law also contains provisions on mortgage registration and foreclosure.<sup>283</sup>

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276. ZHONGHUA RENMIN GONGHEGUO HETONG FA (Contract Law of the People's Republic of China), arts. 79–81, *translated in* LEGISLATIVE AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA, THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1999 9-76 (2000) [hereinafter CONTRACT LAW].

277. *Id.* art. 80. However, simultaneously transferring both the contractual rights and obligations still requires the consent by the counter-party. *Id.* art. 88.

278. *See* Gao & Kruger, *supra* note 270, at 29–30; *see also* Zhou, *supra* note 270, at 18.

279. CONTRACT LAW, art. 87. *See* Gao & Kruger, *supra* note 270, at 30.

280. *Id.* at 30–31.

281. ZHONGHUA RENMIN GONGHEGUO DANBAO FA (Security Law of the People's Republic of China) art. 2, 8<sup>TH</sup> NAT'L PEOPLE'S CONG., 14<sup>TH</sup> SESS., STANDING COMM. (Oct. 1, 1995), *reprinted and translated in* CHINA L. & PRAC. 21 (Aug. 1995) [hereinafter SECURITY LAW]. *See also* Kong, *supra* note 175, at 255.

282. SECURITY LAW art. 34. *See also* Jerome Cohen & John Lange, *The Chinese Legal System: A Primer For Investors*, 17 N.Y. L. SCH. J. INT'L & COMP. L. 345, 370–71 (1997).

283. SECURITY LAW arts 38-44, 53-58.

However, the lack of procedures on registration and foreclosure means that there is no effective protection against subsequent purchasers' claims absent notice of the security interest, and that no efficient means of executing against collateral exists in the event of a default on the underlying obligation.<sup>284</sup>

Provision of foreign-related security is subject to the Foreign Security Procedures promulgated by PBoC,<sup>285</sup> and Foreign Security Implementing Rules issued by Sate Administration of Foreign Exchange ("SAFE").<sup>286</sup> The Foreign Security Procedure recognizes only three forms of foreign-related security interest: guarantees, mortgages, and liens.<sup>287</sup> Under the Foreign Security Implementing Rules, any foreign-related security must obtain SAFE's prior approval.<sup>288</sup> Assignments of foreign-related security rights would require prior consent of the security provider as well as SAFE approval.<sup>289</sup>

#### D. Bankruptcy Law

Although Chinese bankruptcy law is fragmented<sup>290</sup> and under review,<sup>291</sup> general bankruptcy concepts are recognizable in the

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284. Cohen & Lange, *supra* note 282, at 371.

285. Jingnei Jigou Duiwai Danbao Guanli Banfa [Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China Procedures] (Sept. 25, 1996), *reprinted and translated in* CHINA L. & PRAC. 37 (Mar. 1996) [hereinafter Foreign Security Procedure].

286. Jingnei Jigou Duiwai Danbao Guanli Banfa Shishi Xize [Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China Procedures Implementing Rules] (Jan. 12, 1998), *reprinted and translated in* CHINA L. & PRAC. 22 (Apr. 1998) [hereinafter Foreign Security Implementing Rules].

287. Foreign Security Procedures, *supra* note 285, art. 2.

288. Foreign Security Implementing Rules, *supra* note 286, art. 3.

289. *See* Kong, *supra* note 175, at 256.

290. On the national level, there is the Law of the People's Republic of China on Enterprise Bankruptcy (for Trial Implementation), the Company Law, which includes some bankruptcy-related provisions applicable to limited liability companies and joint stock companies, and the Code of Civil Procedure, which includes some bankruptcy-related provisions applicable to legal persons, including joint ventures and other foreign-invested enterprises. On the local level, there are some other regulations relating to bankruptcy and/or litigation. *See* Cohen & Lange, *supra* note 282, at 372.

291. It is expected that the long awaited, comprehensive new bankruptcy law will be promulgated in the near future. *Roundtable Discussion*, *supra* note 229, at 22.

existing regime.<sup>292</sup> Under the various bankruptcy-related laws, a creditor has the right to petition for a debtor's insolvency.<sup>293</sup> After the court's declaration of bankruptcy, a liquidation committee created by the People's court or a court has the power to invalidate transactions occurring six months prior to the date of the acceptance of bankruptcy proceedings by a Chinese court on certain grounds.<sup>294</sup> Secured creditors have priority rights in the property of an insolvent debtor, preempting any competing claims of unsecured creditors to the same debtor's assets.<sup>295</sup>

If the debtor is an SOE, the bankruptcy petition is currently subject to prior approval of relevant authorities.<sup>296</sup> There may be a two-year reorganization period initiated by authorities.<sup>297</sup> If the debtor still defaults on its debt payment upon expiration of reorganization, the court shall declare the debtor bankrupt.<sup>298</sup> While creditors do have the ability to petition for the insolvency of SOEs, for both practical and policy reasons, SOE bankruptcies have been allowed only on an experimental basis and in relatively limited numbers.<sup>299</sup>

### *E. Legislative Uncertainties*

While structuring a securitization transaction within the present legal and regulatory framework is possible, significant gaps exist, presenting substantial uncertainties to the success of NPL securitization. First, although the Chinese laws appear to recognize the concepts of perfection and priority,<sup>300</sup> there is

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292. Gao & Kruger, *supra* note 270, at 33.

293. *Id.*

294. *Id.*

295. *Id.*

296. ZHONGHUA REMIN GONGHEGUO QIYE POCHAN FA (SHIXING CAOAN) (Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation) (Dec. 2, 1986), *translated in* LEGISLATIVE AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA, THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 684-95 (1998).

297. Gao & Kruger, *supra* note 270, at 33.

298. *See Roundtable Discussion, supra* note 229, at 15.

299. *See* Cohen & Lange, *supra* note 282, at 371.

300. "Perfection" refers to protection of a transferee's interest in transferred assets from creditors of the transferor and from the transferor's trustee in bankruptcy. In a securitization transaction, perfection means to protect the SPV's interest in the transferred financial assets from claims of the originator's creditors. *See* Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235, 240 (1998). In the U.S. arti-

no clear guidance on how to accomplish a valid portfolio transfer in securitization where usually numerous obligors are involved.<sup>301</sup> The Contract Law abolished the rule requiring a written agreement for a contract of any kind.<sup>302</sup> The law is silent, however, on whether notice of assignment to the debtor must be given in writing and when such notice may be deemed delivered to the obligors.<sup>303</sup>

Second, Chinese laws have yet to address the issue of a true sale.<sup>304</sup> Some uncertainty remains as to the treatment of recourse and the enforcement of a transferee's right.<sup>305</sup> It is unclear, for example, how the determination of a true sale would be affected when a transaction employs certain credit enhancement mechanisms, such as provision of a guarantee by the originator, or the existence of the originator's right to any surplus collections.

Third, China's existing legal system provides insufficient protection of creditors' rights. For example, the enforcement of

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cle 9 of U.C.C. provides that perfection is achieved by filing financing statements in jurisdictions where the debtor (originator) or the collateral is located.

"Priority" refers to the ranking of multiple claims to the same asset. In bankruptcy, it refers to "a creditor's right to have a claim paid before other creditors of the same debtor receive payment." BLACK'S LAW DICTIONARY 1212 (7<sup>th</sup> ed. 1999). Priority is ascertained by searching filing records to determine whether other parties have prior filings against the relevant collateral or assets. *See, e.g.*, U.C.C. § 9-312(5) (1995).

301. Gao & Kruger, *supra* note 270, at 33.

302. CONTRACT LAW, act 10.

303. Gao & Kruger, *supra* note 270, at 30.

304. A key to a securitization transaction is to complete a true sale as opposed to secured financing. *See supra* note 91.

Arguably, the issue of the SPV's bankruptcy remoteness is less a relevant concern if the originator is a state-owned Chinese financial institution, for example, an AMC, which is deemed usually unlikely to go bankrupt. However, in 1999, the Chinese central government refused to rescue the insolvent Guangdong International Trust and Investment Corporation ("GITIC"), which was the second largest of its kind in China and owned by the Guangdong provincial government. *See Lou, supra* note 33, at n.18. *See also*, Ben Branch & Fei Ji, *Bankruptcy Practice in China, Hong Kong and Taiwan: A Summary*, 2002 ANN. SURV. OF BANK. LAW 341 (2002). The GITIC's bankruptcy raised foreign creditors' concern with the increasing possibility of the bankruptcy of state owned financial entity as the government takes more sweeping financial cleanup. *See, e.g.*, Karby Leggett, *China's Credit Costs Go On Trial With GITIC*, ASIAN WALL ST. J., March 29, 1999, at J3, available at 1999WL 5430580.

305. Gao & Kruger, *supra* note 270, at 32-33.

mortgage foreclosure is notoriously difficult. In addition, China's fragmented bankruptcy law does not provide an orderly framework for the reorganization and liquidation of insolvent enterprises.<sup>306</sup> Furthermore, the judicial and administrative discretion involved in the decisions to commence a bankruptcy proceeding against an SOE debtor creates unpredictability in the enforcement of creditors' rights. Thus, the lack of experience in administrative proceedings further compounds the difficulty.

Additional uncertainties arise when foreign investors participate in China's NPL resolution. Recently, the Chinese government issued two new regulations relevant to foreign investment in NPL market.<sup>307</sup> Obviously, the government has recognized the importance of involving outside funds and expertise to resolve NPL issue as well as the closely related conundrum of SOE restructuring. The multi-departmental regulatory regime and opaque approval procedure, however, make it very difficult to accomplish a transaction with foreign participation. In addition, there are also restrictions on the kind of SPVs that foreign investors may set up to take over NPLs.<sup>308</sup> Finally, foreign investors are concerned with China's foreign exchange controls imposed on profit repatriation.<sup>309</sup>

#### *F. Proposal for Special Legislation*

China currently does not have a comprehensive legal framework for carrying out securitization. Of course, given the manifested governmental support, the AMC's may well be able to securitize NPLs based on the existing laws and regulations.<sup>310</sup> This approach, however, lacks certainty and predictability, as ad hoc interpretations of ambiguous provisions by various government agencies may result in regulatory conflicts. Moreover,

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306. Cohen & Lange, *supra* note 282, at 372.

307. Interim Rules on Financial Assets Management Companies' Absorption of Foreign Funds for Assets Reorganization and Disposal (promulgated on Oct. 26, 2001 by MOFTEC, MOF, and PBoC); Provisional Rules on Reorganization of the State owned Enterprises by Using Foreign Fund (promulgated on Nov. 8, 2001 by the State Economic and Trade Commission, MOF, SAIC, and SAFE), available at <http://www.isinolaw.com>.

308. *China Needs to Revise Laws, Provide More Transparency For NPL Sales*, AFX-ASIA (Nov. 5, 2001), available at LEXIS News.

309. *Id.*

310. Interview with Yang, *supra* note 6.

validating every stage of a transaction would entail “a Byzantine process of obtaining consents and approvals from a panoply of government bodies.”<sup>311</sup> Thus, the AMC's may encounter substantial difficulty while experimenting with NPL securitization.

Therefore, enacting special legislation is the preferable approach to resolving uncertainties and to paving the way for securitization. In modeling this new securitization law, China may borrow the asset securitization acts passed in Korea and Taiwan. The new law could provide for securitization as a general financial technique and give special accommodation for NPL transactions.

In establishing a comprehensive regime for securitization, the proposed new law should fill the legislative gaps discussed earlier. For example, with respect to possible SPV structures, China may choose to follow the Korean approach, providing for both SPC and SPT, or the Taiwanese approach, which allows only the use of SPTs. As for the true sale issue, China's proposed law may specifically define the relevant criteria as in the Korean legislation. Alternatively, the proposed law may leave the issue open to the courts when disputes arise. The first option suffers from inflexibility, while the second approach flaws with the unpredictability and may fail due to the current judicial incompetence in China. In addition, clear notice procedures should be set up for perfecting an asset transfer. Notice should be deemed given where certified mail has been sent to the obligor at the address appearing in the registration at the State Administration of Industry and Commerce, or in absence of that, to the last known address. If on at least two occasions the mails have returned undelivered, a public notice published in generally circulated newspapers should be deemed valid. Finally, to encourage international participation, the proposed law should also provide for clear guidance on foreign-related issues, including, for example, setting up of a foreign-involved SPV, provision of foreign security, and repatriation of profits overseas.

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311. Balbir Bindra, *Legal Initiatives to Promote Securitisation*, available at <http://www.vinodkothari.com/secchina.htm> (last visited Feb. 14, 2003). For example, Huarong's first international NPL auction took a year to obtain approvals from all relevant authorities.

## VIII. CONCLUSION

Resolving the mammoth NPLs burdening China's fragile banking sector is certainly a long march. Any procrastination in implementing NPL disposals, however, could ultimately lead to much greater fiscal burdens, due to the "ice cream effect."<sup>312</sup> The Chinese government has realized the seriousness of the problem and has demonstrated considerable resolve in attacking it.

Securitization has been successfully utilized in the U.S., Japan, Korea, and many other countries as an option of NPL disposition. The Chinese AMCs mandated with NPL resolution are currently exploring NPL securitization. As this Note has suggested, however, the unique nature of Chinese NPLs, the underdevelopment of its capital markets, and the lack of comprehensive legal framework present substantial obstacles to a large-scale NPL securitization program in China. While the bulk of Chinese NPLs are not suitable for securitization, this Note indicates that of the massive portfolio held by the AMCs certain loans are nonetheless securitizable. The Chinese AMC may therefore embark on their pilot NPL securitization program from this identified portion of NPLs. Successful NPL securitization would not only contribute to the ultimate resolution of China's NPL issue, but would also assist the general development of securitization in the local markets.

To facilitate localization of this financial technique, the Chinese government must address the existing market and legal obstacles. This Note thus stresses that the government should further liberalize capital markets, allowing greater participation of both domestic and foreign institutional investors. In addition, this Note proposes enacting special securitization legislation to establish comprehensive and predictable legal infrastructures.

*Hui (Hannah) Cao\**

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312. See *supra* note 21 and accompanying text.

\* Candidate for J.D., Brooklyn Law School, 2003; M.A. in International Relations, Yale University, 2000; B.A. in International Economics, Peking University, 1994. Employed at the Industrial and Commercial Bank of China from 1994 to 1998. The author would like to thank Professor Edward J. Janger at Brooklyn Law School for his valuable advice on this Note, and Kai-sheng Yang, Chairman of the China Huarong Asset Management Corporation,



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