

Title: **Launch of the Securitization Market in the PRC? Still A Long Way to Go**

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Notwithstanding the fact that the present PRC legal and regulatory framework is still unready to accommodate any onshore securitization transaction, more attention has been paid to this relatively new financial technique by the regulators, bankers and some potential originators in the past year. Although no substantial progress has been made, some developments in the legislation have, to an extent, cleared a few hurdles in structuring a real onshore securitization in China.

Positive Developments in Legislation

New contract law

The new PRC Contract law, effective on October 1 1999, has deep impact on transfer of receivables. Before the new law took effect, a mere notice to the debtor was not sufficient to constitute a valid transfer under PRC law, unless the consent from the debtor is obtained. According to the new law, a contracting party will be able to transfer its rights under the contract by serving a notice to its counter-party, (Article 80, PRC Contract Law. However, according to Article 88, the simultaneous transfer of both the contractual rights and obligations is still subject to the consent by the counter-party). This means that the transfer of receivables, as a kind of contractual rights can be made without obtaining consents from the debtors. The transfer of receivables, as a usual step in a securitization transaction, will become more practical and feasible from a business point of view.

Trust Law

The suspended legislative review of the draft trust law has recently been reactivated. It is expected that the trust law will come into effect in the foreseeable future.

Substantial Legal Hurdles

Substantial obstacles still remain under the PRC legal framework for a securitization transaction. These include:

Difficulty in incorporation of SPV

PRC companies are only permitted to conduct their businesses within the scope

approved by the State Administration of Industry and Commerce (SAIC). The purchase and sale of receivables are likely to be deemed as a financial service, and industry that is still heavily regulated. A special purpose vehicle (SPV) with thin capital is unlikely to get licence to conduct such activity. Meanwhile, due to the lack of the trust concept under PRC law, a trust structure cannot serve as an alternative.

Limited access to the domestic bond market

The domestic bond market is only available for those enterprises generating profits in the past three consecutive years and the average profit generated during such three-year period must enable the issuer to repay one year's interest on the bonds issued (Clause 159, PRC Company Law, December 29 1993; Regulation on Administration of Enterprise Bonds, August 2 1993). It is unlikely that a newly-established SPV will satisfy such a stringent requirement.

Security over receivables

PRC laws tend not to recognize the security over the future receivables. Even for the existing receivables, it is questionable whether a pledge can be established thereon. (It is unclear under the PRC Security Law if the contractual rights can be pledged. Recently, some international lenders have taken pledge over the take-or-pay contracts in some project finance transactions in the PRC. However, the opinion of PRC courts in terms of such pledge over contractual rights, in the event of disputes, remains unclear). Therefore, the investors may not be able to take security over the receivables that the SPV purchased. Consequently, some securitization structures used in other countries may not be adopted in the PRC.

All these legal hurdles may not be easily cleared by mere improvements of the transaction structures. And it is unlikely that the government will systematically change all those laws and regulations relevant to the securitization structure within the foreseeable future. Special legislation on securitization seems to be requisite to pave the way for the launch of the securitization market in the PRC.

True Sale And Tax Neutrality

No recent legislation has been passed that may affect the judgment on the true sale and tax neutrality. As to the true sale, like in other jurisdictions, it is essential to make sure that the originator has the valid title over the receivables and that the transfer of such receivables comply with all the legal requirements. As a result, the debtors and any third party will have no recourse to the receivables transferred. Meanwhile, the bankruptcy concern of the originators will always have to be cleared before a true sale can be completed.

Since value added tax does not apply to the transfer of receivables, it will not be very

difficult to achieve tax neutral position under PRC law.

Offshore Securitizations

Although it is, still impossible to structures onshore securitizations, it may be possible to securitize receivables originated from the PRC in the international debt markets. Under such a scenario, the SPV can be established in foreign jurisdiction, usually a tax haven, and most arrangements in a securitization transaction can be made under foreign laws. However, it is essential to make sure that the sales of receivables by PRC originators to the SPV are recognized as a true sale. Such true sale could be achieved provided that all the PRC legal requirements have been complied with, and we do not see any legal obstacle preventing such a transfer.

In addition, concerns about the foreign exchange administration of the PRC government have to be eliminated. The PRC government still exercises strict control over the conversion between Renminbi and foreign currencies under capital accounts. It is unclear whether the PRC government will regard securitization as a financing in substance rather than sales of receivables by Chinese companies to the foreign SPVs. If it is the case, the sale of Renminbi receivables may be deemed to be capital accounts transactions that require approval by the PRC government.

It is clear that the PRC still has a long way to go to launch its domestic securitization market. The efforts towards establishing a framework for securitization purposes continue to be made and it is expected that progress may accelerate in the near future.