Growing Asia's Markets

ASIFMA – Securitization in Asia 2015

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ASIFMA is an independent, regional trade association with over 90 member firms comprising a diverse range of leading financial institutions from both the buy and sell side including banks, asset managers, law firms and market infrastructure service providers. Together, **we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia.** ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive **consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice.** Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and 4 the cost of doing business in the region. Through the GFMA alliance with SIFMA in the US and AFME in Europe, ASIFMA also provides insights on **global best practices and standards to benefit the region.**

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I. Executive Summary (ASIFMA)

As a tool to diversify and disperse risks, securitization has played a vital role in developed markets for an extended period of time – As the range of securitized products and markets have grown in terms of variety and sophistication, a wider range of investors and market participants have recognized the potential for securitization to meet the twin objectives of (a) enhanced return and (b) portfolio diversification. Given the success that securitization has enjoyed globally, the time has come for the effective use of this tool across Asia – with one market in particular standing out for the spectacular strides that it has made over the last few years – China.

While it is true that several markets in Asia have established securitization frameworks of varying degrees of sophistication over the years, the fact remains that by and large, this has remained an under-utilized tool – while there was some momentum seen in terms of growing volumes and variety in the range of product offerings (particularly those accessible to international investors – primarily CDOs) in the years leading up to the Global Financial crisis (GFC), this trend slowed (and in some cases even reversed) post the GFC.

That said, some of the Asian markets that have seen reasonable volumes of domestic securitizations, in the years after 2008-09 include Korea, Singapore, Thailand and as pointed out above, China. In fact, from a near standing start, China has over the last two years, surpassed Korea to become the largest Asian securitization market. This is a promising development (and one topic that this document focuses on) worth watching closely – the opening of China's securitization market to international investors, the adoption of global ratings standards and the diversification of Chinese issuers both by issuers and product type would be a most welcome development. Moreover, this would also represent one more step in the internationalization of the renminbi, a process that is well advanced.

The organization of this document follows a logical trajectory – Beginning with the origins and broad description of what securitization represents and the benefits it confers for issuers and investors alike (Chapter II), the document then describes the state of securitization in China, the main focus of this document (Chapter III) and other select Asian markets, besides the mature markets of the US and Europe (Chapter IV). The next chapter (Chapter V) looks at covered bonds and the development of the framework for the issuance of these bonds in Asia. The subsequent chapters (Chapters VI and VII respectively) cover how a) securitization structures are rated and b) tax issues in securitization, respectively. Chapter VIII looks at the existing regulatory frameworks governing securitization and the ways in which these regulations could be made more efficient, especially where there are overlaps. Chapter IX looks at the way forward for Asian securitization, particularly in the Chinese context while the final chapter (Chapter X) considers the outlook for cross-border issuance, in what have largely been domestic markets.

In summary, the goal of this document is to serve as a primer for the state of securitization in Asia and make the case for its continued development in the months and years ahead, with a particular focus on what has already become the largest market for Asian securitizations – China.

II. What is Securitization (Clifford Chance)

Securitization has many advocates.

A market for prudently designed ABS has the potential to improve the efficiency of resource allocation in the economy and to allow for better risk sharing. It does so by transforming relatively illiquid assets into more liquid securities. These can then be sold to investors, thereby allowing originators to obtain funding and, potentially, transfer part of the underlying risk, while investors in such securities can diversify their portfolios in terms of risk and return. This can lead to lower costs of capital, higher economic growth and a broader distribution of risk.

European Central Bank and Bank of England joint paper
April 2014

The credit-availability pendulum has swung, as it was bound to do, in reaction to poor performance of the underlying assets, home price instability, and a lack of investor demand for anything other than a government-guaranteed product. As these factors abate, underwriting standards will need to find a new equilibrium of risk and reward for a sustainable mortgage market. Getting the securitization pipeline flowing again is a critical component in turning this picture around.

Thomas J. Curry, Comptroller of the Currency
January 2013

…securitization could be the "financing vehicle for all seasons" if proper standards are maintained […]. In a world where we are squeezing risk out of the banking system we would want a simple, safe, vibrant set of channels for non-bank financing to emerge and securitization is one of those.

Andrew Haldane, Direct of Finance Stability at the Bank of England
December 2013

Securitization is a useful funding technique for financial institutions, and an efficient means to diversify risk.

Financial Stability Board, Shadow Banking: Strengthening Oversight and Regulation
October 27, 2011

We think that a revitalization of a certain type of [asset-backed security], a so-called plain vanilla [asset-backed security], capable of packaging together loans, bank loans, capable of being rated, priced and traded, would be a very important instrument for revitalizing credit flows and for our own monetary policy.

Mario Draghi, President of the European Central Bank
March 2014

1. **Back-to-basics**

Features

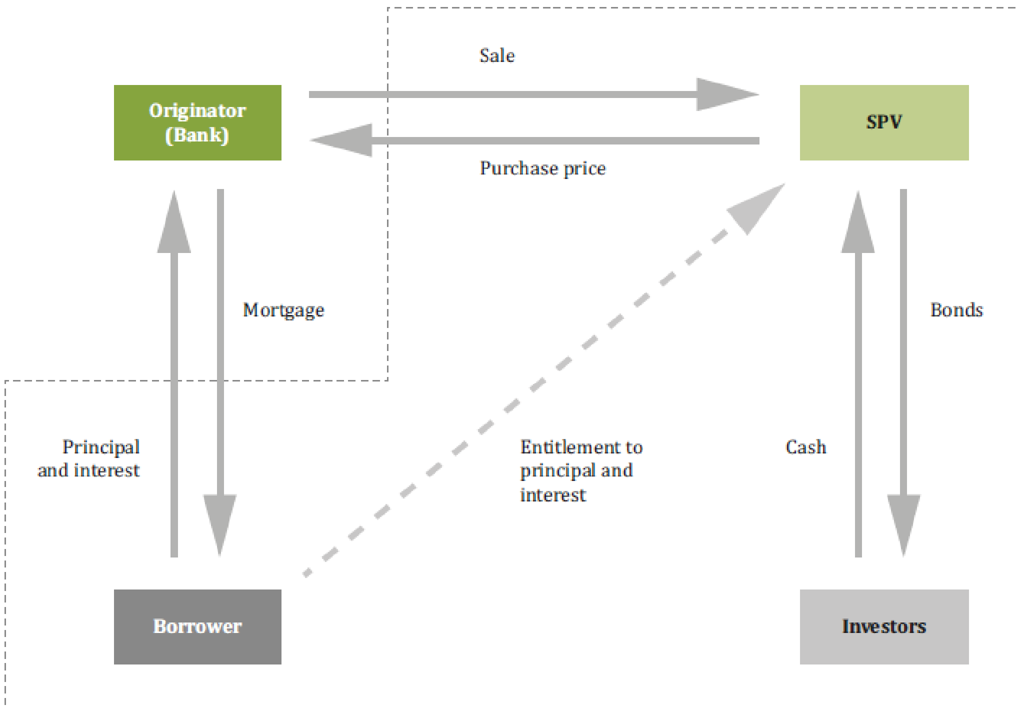
"*Securitization*", as a term, is used colloquially to refer to a wide and diverse range of financial products. At its core, however, securitization should be thought of as a set of techniques, or tools, rather than a particular product. The presence of these techniques in a transaction or structure are hallmarks that that transaction or structure is a securitization. These techniques, or hallmarks of securitization, are:

- a pooling of assets;
- divorcing the credit risk of those financial assets from the credit risk of the entity to which they are currently owed; and
- using the cash flow from those assets to repay an investment.

Capital markets investors, such as banks' treasury departments, insurance companies, pension funds and a range of investment funds, are able to make use of these techniques to provide funding for real economic activity by banks and corporates. Such transactions are very common throughout Europe and the United States.

The following diagram illustrates a typical residential mortgage backed securitization transaction.[1]

Figure 1: **A basic securitisation structure**



The **Bank** (the **Originator**) grants a mortgage to the **Borrower**, who in exchange pays principal and interest.

The **Bank**, the owner of the assets, sells a pool of mortgages that are to be securitised to an **SPV** (Special Purpose Vehicle). An SPV is a stand-alone entity, created exclusively for the purpose of the securitisation.

The SPV pays the purchase price to the bank by issuing debt securities (bonds) to investors, typically on a floating-rate basis. The interest payments to investors are funded by cash flows generated by the underlying assets.

Although the Borrower still makes payments to the originator – usually also the servicer of the mortgages – the entitlement to the principal and interest is transferred to the SPV via a ring-fenced (dotted line) financial structure protecting the bonds from a default of the Originator.

Securitization structures

There are many ways in which securitization techniques are employed in transactions and in the boxes over the next few pages you will note the differences between true sale securitizations, covered bonds, master trusts, whole-business securitizations and trade receivables securitizations.

Asset classes

A range of financial assets are regularly securitized in Europe and the US and these include, among others:

- residential mortgages;

[1] AFME – *High quality securitization for Europe – June 2014*, diagram on page 5.

- commercial mortgages;
- auto-loans and leases;
- consumer loans;
- credit cards;
- trade receivables;
- corporate loans (including SME loans); and
- project finance loans.

Each asset class has its own peculiarities which result in, sometimes nuanced, differences in the way transaction involving them are structured. Due to differences in asset quality or legal systems (which can each also, in turn, drive differing requirements from rating agencies), some jurisdictions often favor some asset classes over others.

2. The old axioms of securitization and the global financial crisis

Prior to the global financial crisis arrangers, originators and investors alike, believed axiomatically that securitization was beneficial to the economy for a number of reasons. Included among these reasons was the thinking that securitization, simply of itself, provided greater market liquidity and market completion – by slicing and dicing risk and allowing investors to choose what level of risk they wanted, it created a more efficient, financially stable market. The credit creating effect of securitization was also widely considered beneficial on the basis that additional credit meant there could be additional growth.

However, the global financial crisis turned these perceived principles on their head – the way the financial industry had been operating in the preceding years had resulted in a build up, not a reduction, of risk and credit creation fueled inflation. Financial institutions had also become more interconnected which meant, when the crisis began, losses were quickly transmitted around most economies in the Western world.

The role of securitization in an economy, and the "shadow banking" sector where securitization techniques were frequently employed, was then brought into sharp focus. With hindsight, the way securitization had been used in some contexts – such as in SIVs[2], CDO^2s[3], originate-to-distribute[4] business models and capital arbitrage[5] transactions – had contributed to the build-up

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2 SIV – a structured investment vehicle. These vehicles typically issued short term commercial paper to finance a pool of securities which it bought and sold. A SIV would make a spread by arbitraging the short term nature of its funding with the longer term nature of the securities it bought and sold.

3 CDO^2s – a collateralized debt obligation squared. A collateralized debt obligation is a transaction whereby a pool of securities are purchased by an SPV, financed by that SPV issuing its own securities. A CDO^2 is a CDO of a CDO – i.e., an SPV which purchases securities which have been issued as part of a CDO.

4 "originate-to-distribute" – a business model employed by a number of investment banks and other market participants where mortgage loans, corporate loans or other financial assets were originated solely for the purpose of securitizing them. As the business originating the loans was transferring all the risk in all the loans to a securitization, there was little, or no, incentive for that business to engage in sound underwriting practices – the credit quality of the loans in the securitization might then be significantly less than a securitization investor would expect.

of risk which, alongside the broader effects of "shadow banking", had led to a less stable financial system.

What became clearer though, was that securitization was a tool, not something which had effects in and of itself. If securitization is used in a particular way, it can have very serious consequences but when used in other ways, it can bring very significant benefits.

3. How securitization can be used to benefit the economy and strengthen the financial system

Whatever benefits securitization can bring, it is widely believed by regulators in both Europe and the US, that securitization should be regulated – boundaries are being drawn around the scope of what securitization can and cannot be used for. To achieve some of the benefits outlined in this section, proper regulatory scrutiny would like be needed – the possible regulatory options for positive securitization in China are explored further in Chapter 3.

Reducing an overreliance on the banking system

One risk highlighted by the global financial crisis, particularly in Europe where bank assets were three times European GDP, was an overreliance on the banking system as the provider of credit for the economy. The "credit crunch" experienced in Europe resulted from the banking sector cutting the amount of credit it provides in the wake of increased capital requirements and a general desire to engage in less risky activity. As banks were the main provider of credit many companies became unable to access the finance they needed.

Securitization is a tool that can be used to deal with this problem in two ways. First, it can be used by corporates who would otherwise be reliant on bank funding to securitize their assets and access the capital markets as a funding source directly (for instance, utility companies or corporates with large portfolios of trade receivables). Second, it can be used by banks to distribute their existing risk to the capital markets thereby freeing up their balance sheets to undertake more lending themselves. This latter use has two benefits – (a) spreading risk more widely around the financial system (ensuring not too much is concentrated just in the banking sector) and (b) facilitating the extension of further credit through an already existing banking system.

Additional non-bank credit provision

Having a wider proportion of credit provided by non-banks (by accessing the capital markets through securitization) can have a positive effect on financial stability. Non-banks are typically less vulnerable to the risks inherent in the banking system – for instance (a) they are less reliant on short-term funding sources (such as customer deposits or interbank lending), (b) they have less complex balance sheets and (c) they are typically less leveraged than large banks as they would not benefit from the "too-big-to-fail" subsidy. Moving more risks from banks to non-banks would means that a shock in the banking system would not necessarily involve issues among non-banks resulting in credit continuing to be available through that channel despite issues in the banking system.

[5] capital arbitrage – entities subject to capital requirements rules might be able to engage in an arbitrage transaction, whereby the capital they need to hold against a particular asset might be significantly less if held through a certain transaction structure compared to another whereas the underlying risk in the asset would remain the same.

Non-maturity transforming credit

Securitization can offer credit in a way which is not maturity transforming – securities can be issued with a tenor many years into the future. Banks tend to avoid such long commitments as they are generally receiving their own funding on a short term basis. By enabling access to investors who are willing to accept or desire longer tenors, the borrowing needs of people who and companies which need long term credit can better be met.

Two key areas where securitization can help in this manner are residential mortgage borrowing and infrastructure borrowing – in both instances there is a desire for long term credit over many years which can be met through securitization.

An investment instrument

Securitization can repackage illiquid assets into liquid securities. Some non-bank investors, such as insurance companies and pension funds, are reluctant to grant loans directly on the basis there is limited liquidity if they wish to transfer that risk further down the line. By holding liquid securities, rather than a loan, it means that position can be readily sold on, if the investor so chooses.

Diversification of risk

Securitization offers investors, both banks and non-banks alike, the opportunity to diversify their portfolios, whether in terms of risk profile, geographical location or liquidity. Rather than simply buying corporate bonds or shares, which depend on the risk of a corporate as a going concern, an investment in a securitization gives exposure to an underlying pool of assets – a different type of risk which can bring more diversity to, and therefore will reduce overall risk in, an investment portfolio.

Tranching

The securitization technique of tranching means that securities representing interests in the same asset pool can be given different risk profiles. This is done through a legal technique called a waterfall or a priority or payments.

For instance, a pool of residential mortgages with a face value of 100 might be transferred to an SPV and the SPV issues 100 of notes to fund that acquisition – 50 "A" notes, 30 "B" notes and 20 "C" notes. The transaction documents will provide that as the residential mortgages are repaid by the underlying borrowers, the cash collection are used first to redeem the A Notes, second to redeem the B notes and finally to redeem the C notes. The result of creating this priority is for the C notes to take the "first loss" on the pool – i.e., any losses up to and including 20% would result in the holders of the C notes losing out without the A noteholders or B noteholders taking any losses. Losses in this pool between 20% and 50% would be bourne by the B noteholders and the A noteholders would begin to experience losses only in excess of 50% of the entire pool. The A notes therefore have significantly less risk attached to them than the C notes, but will likely yield a much smaller margin to investors holding them.

Thereby through tranching a ready supply of high quality low risk securities can consequently be provided for investors through the use of securitization, provided the underlying assets are, overall, of a sufficiently high credit.

Banking stability

Securitization can also be used by banks to help reduce some of the risks inherent in banking activity. This can be done by:

- better matching the bank's assets to its liabilities – by having funding provided to the bank with the same tenor as it requires to lend;
- better risk management – by imposing reporting and information requirements on a bank reporting to its investors it is incentivized to continue to accurately monitor the risks of the assets it is funding;
- wider investor base – investors in securitization are an alternative source of funding for banks, aside from depositors, interbank lending and bonds, providing banks with a more even source of funds making them more resilient to shocks or reductions in credit in one investor base; and
- cost of funding – by better matching an investors appetite to risk through tranching or the credit quality of the underlying assets a bank can better price its securitization funding thereby resulting in cheaper funding for it than might be available through other secured funding channels.

4. Ratings in securitizations

Rating agencies are often engaged in securitization transaction in order to provide investors with a view on the likelihood of the ultimate repayment of principal on a particular class of notes and/or the expectation or timely payment of interest on a particular class of notes. There are a number of factors which a rating agency will take into account when assigning a rating to a particular transaction. These factors include the following and are explored in more detail in Chapter VI:

- the quality of the underlying assets;
- the historic performance of the assets originated by the originator;
- the credit policies of the originator in extending credit to its customers;
- the quality and capability of the servicer of the underlying assets;
- the ease with which the servicing function might be replaced upon the insolvency of the servicer;
- the jurisdictions in which underlying debtors are located;
- the cash flow waterfall structure and position within the structure of any related tranche;
- the strength of any legal opinions provided as to the insolvency-proof nature of the transaction.

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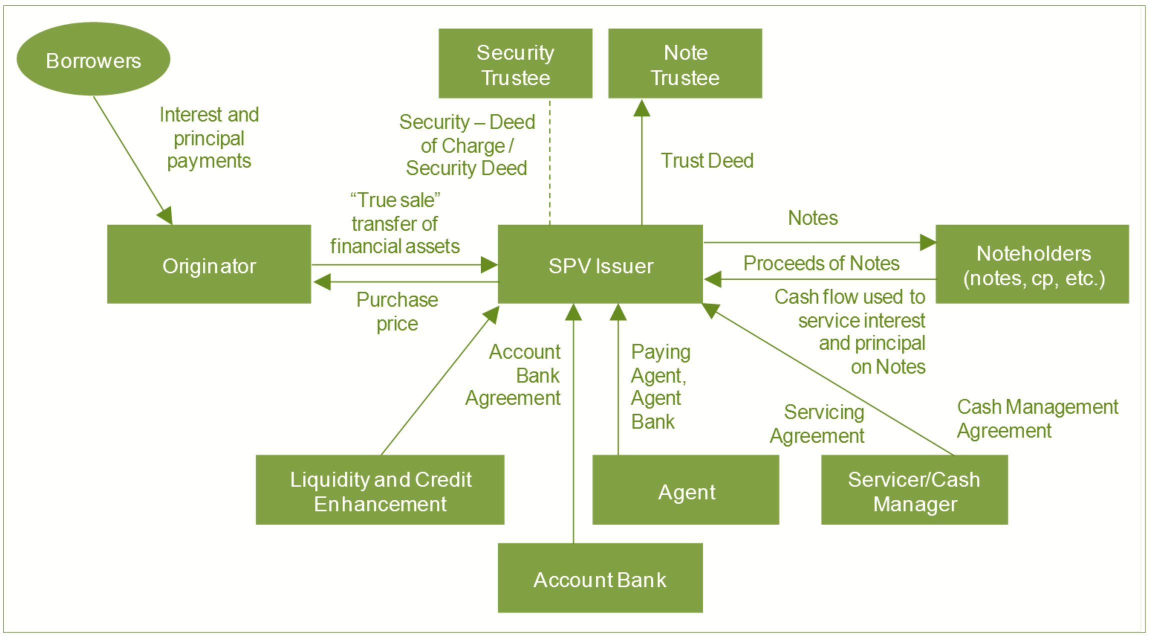
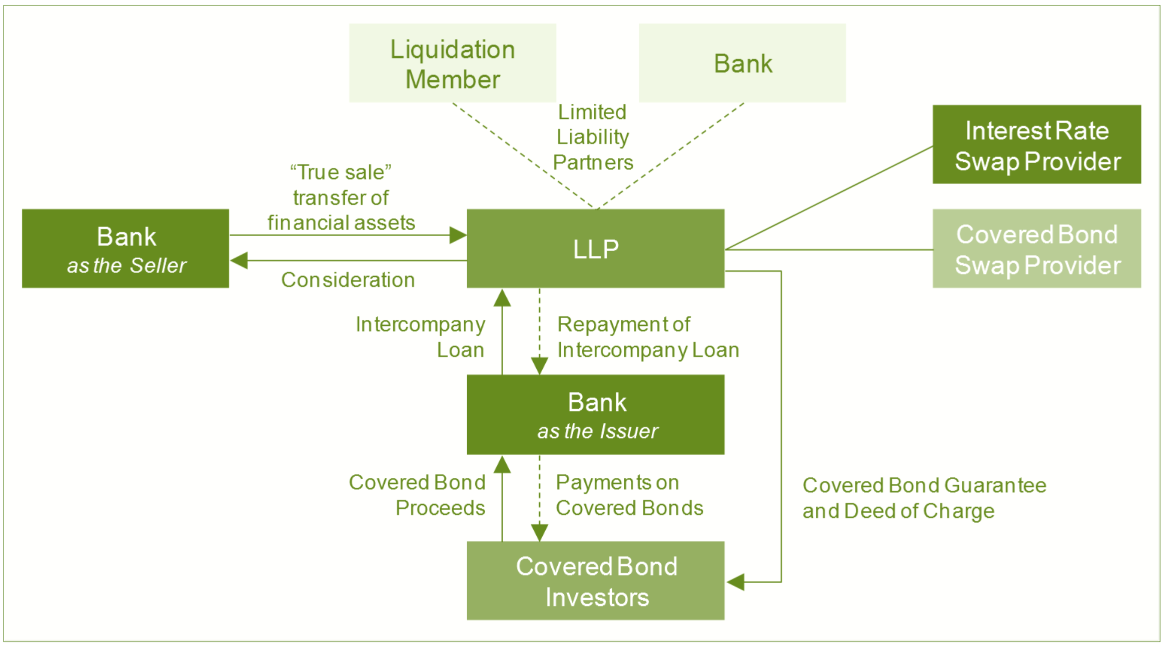
True sale securitization

In a true sale securitization the originator sells its financial assets (residential mortgages are a classic example in Europe) to an SPV issuers which finances the acquisition of those financial assets by issuing notes. The notes would typically be listed and rated by at least two rating agencies. Liquidity and credit support would be provided to the SPV to protect against fluctuations in the cash flow and deterioration in the pool of financial assets. The notes would usually be tranched.



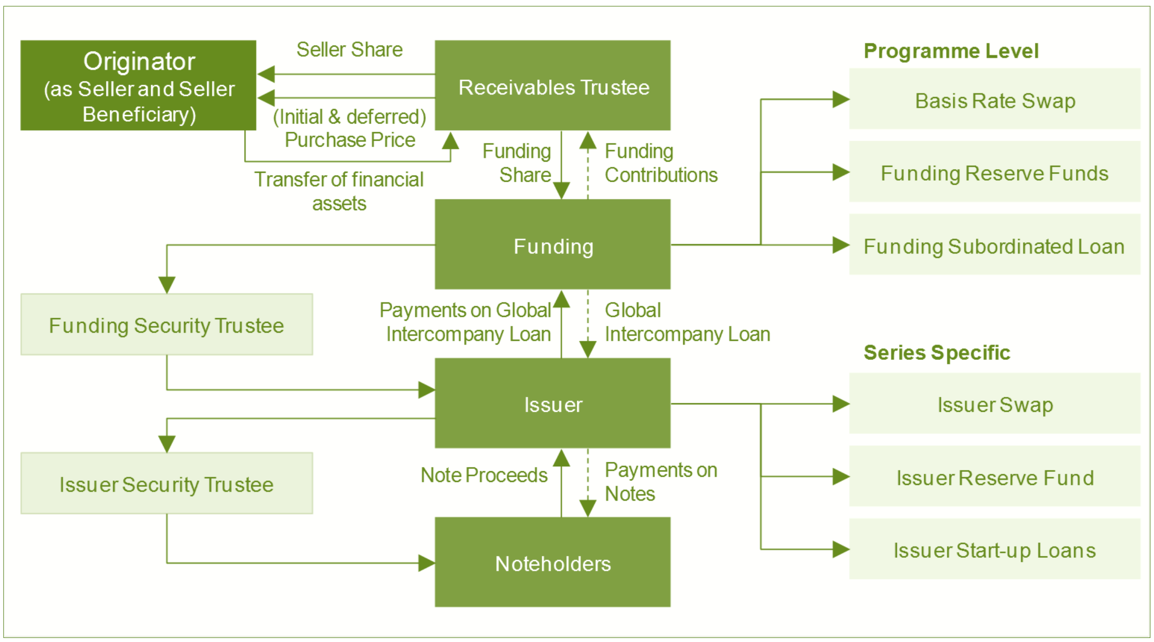
Covered bond

This diagram shows a typical UK covered bond structure. Under a covered bond investors have recourse to both the bank as the issuer and the pool of assets which have been segregated. In some jurisdictions legislation provides the legal basis for the segregation (a so-called "statutory ring-fence") whereas in others, such as the UK, an SPV (which typically take the form of a LLP) needs to be set-up for the purpose.



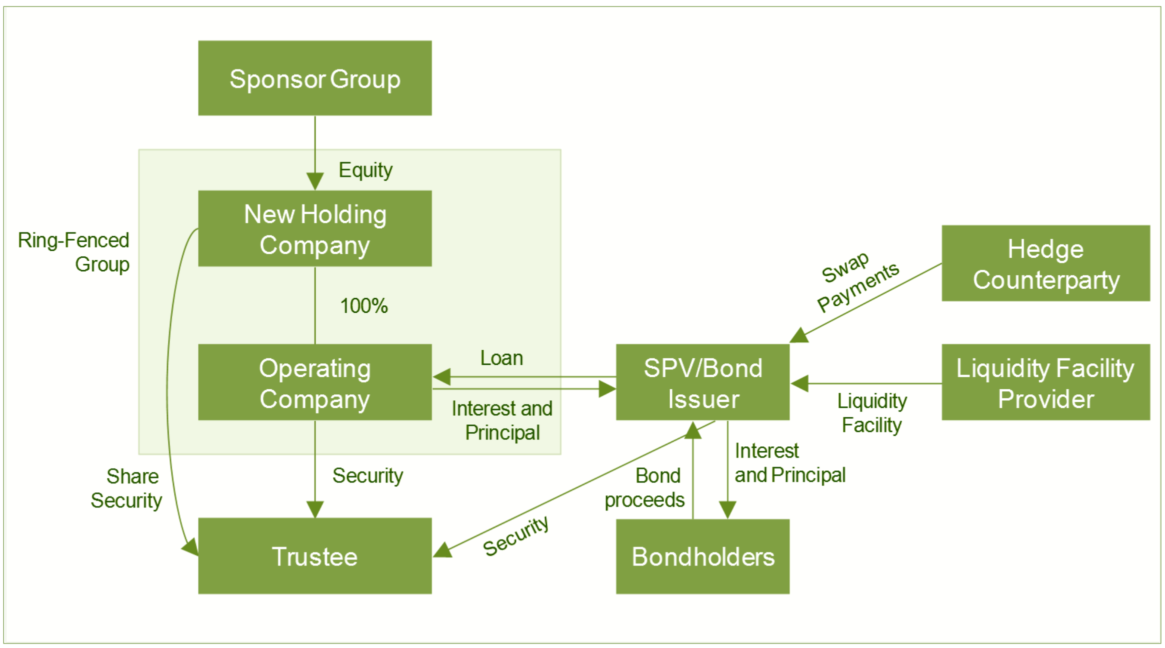
Master Trust

A master trust is effectively set up to permit regular programmatic issuance by an originator which a steady supply of financial assets – for instance an active residential mortgage originator or a credit card company. A "platform" is established pursuant to which the originator continually transfers its newly originated assets to a trustee (in the example below, a Receivables Trustee) which declares a trust over the assets for the benefit of the originator and intermediary funding vehicles (in example below, Funding). Each time the originator wishes to raise finance, the note issuing vehicle (in the example below, the issuer) will issue a series of notes which will be backed by the assets held by the Receivables Trustee.



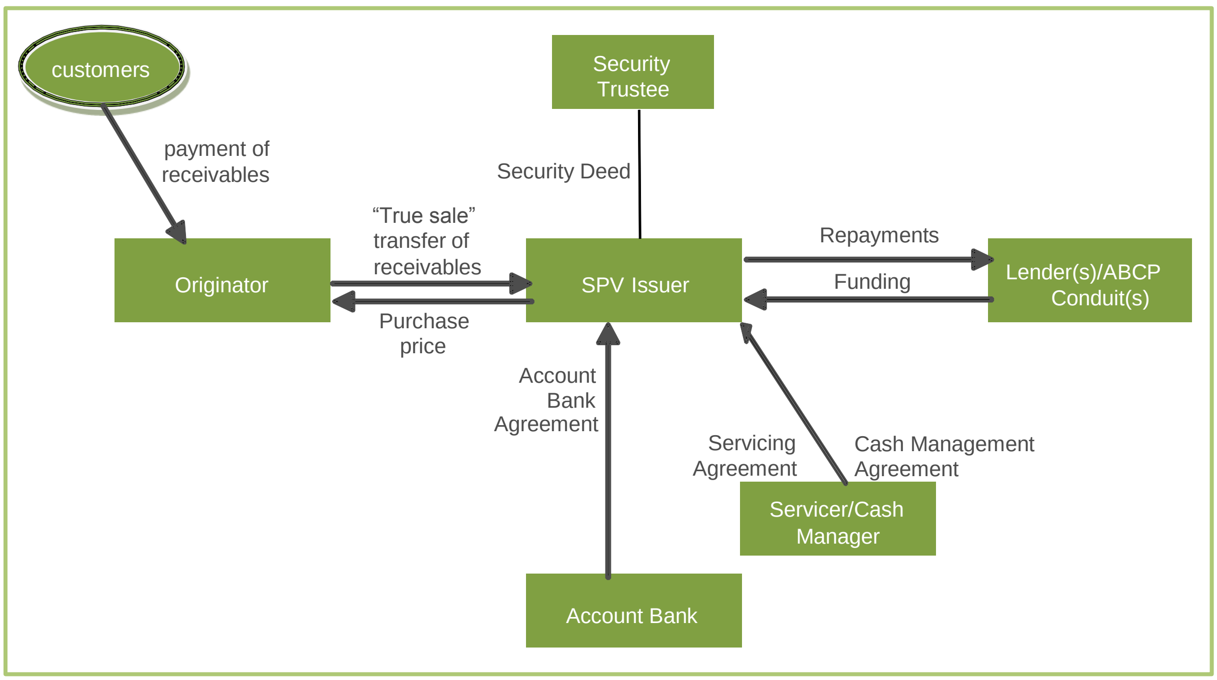
Whole-business securitization

Whole-business securitizations are used to provide corporates, which have either steady or regulated income streams, to raise finance in the capital markets – typical examples include ports, airports, water companies and holiday parks. A security net is placed over the revenue generating entities and assets within the group (creating a ring-fence around those entities and assets) to isolate the cash flows and all creditors (e.g., capital markets investors, swap providers, capex lenders, term facility providers, working capital lenders) to that group agree on a common set of representations, covenants, events of default and SPV issuer is a creditor of the group which raises finance in the capital markets by issuing notes giving capital markets investors exposure to the group.



Trade receivables securitizations

In a trade receivable securitization, a corporate originator is provided with funding very similar in nature to a working capital facility while the lender (or other funder, such as an asset-backed commercial paper conduit) has credit risk on the originator's customers, rather than the originator itself. The credit risk of the originator's customers is achieved through a true sale of the receivables those customers owe to an SPV. There would typically be a single "tranche" of funding provided by third party financiers, while the originator would provide credit enhancement, either by selling the receivables at a discount (being entitled to deferred consideration only if they collect) or providing a junior tranche of funding to the SPV. Additional credit enhancement might also be provided through the provision, by an insurer of an insurance policy, protecting against credit default by the customers.



Disclaimer: Please refer to Appendices, page 89.

III. State of securitization in China (King & Wood Mallesons)

1. Overview – Securitization in the PRC

China's securitization industry has seen explosive growth in recent years. In 2014 alone, the volume of domestic ABS issuances grew to approximately RMB 280 billion, a tenfold increase year-on-year, and this figure was higher than the aggregate issuance volume for the past 8 years combined. As of April 2015, statistics from the PBOC suggest that the total outstanding ABS in the domestic PRC market stood at approximately RMB 300 billion. All this represents a remarkable turnaround from the tentative stop-start approach taken by the PRC regulators for the best part of the past decade.

Securitization was first introduced into the PRC through a pilot program in 2005 and was suspended in 2008 following the onset of the global financial crisis amidst concerns relating to securitized assets. The pilot program was subsequent restarted in 2012 with an initial quota of RMB 50 billion. This has since been further increased to RMB 500 billion pursuant to an announcement by the PRC State Council on May 13, 2015. Even so, the latest quota represents only a fraction of the potential size of the asset pool that could be ripe for securitization. In May 2015, the Financial Times, quoting a senior official from the CBRC, suggested that there may be a pool of RMB 90 trillion worth of securitization-eligible bank loans in the PRC, and this is just one of the many asset classes suitable for securitization.

In this article, we will explore the regulatory landscape for ABS in China, the recent developments and latest trends in ABS-product offerings. Against this backdrop, we will summarize the opportunities available for financial institutions keen for a piece of the action (in various capacities including as originator, underwriter, structuring advisor and investor). We will look into how the PRC legal framework addresses the common legal issues relating to ABS issuances. Finally, we highlight potential areas for reform to further develop the PRC securitization market – these proposals include a streamlined regulatory framework, access to a wider pool of investors, and support for cross-border ABS issuances.

By addressing the most common concerns raised by all stakeholders including regulators, bankers, originators, investors and lawyers, we hope to have something useful for everyone in ASIFMA's big, happy family.

2. The PRC regulatory landscape

Within PRC, there are 2 broad securitization frameworks in place, with each promulgated by a different regulator and targeting a different group of originators. The two structures are described in further detail below.

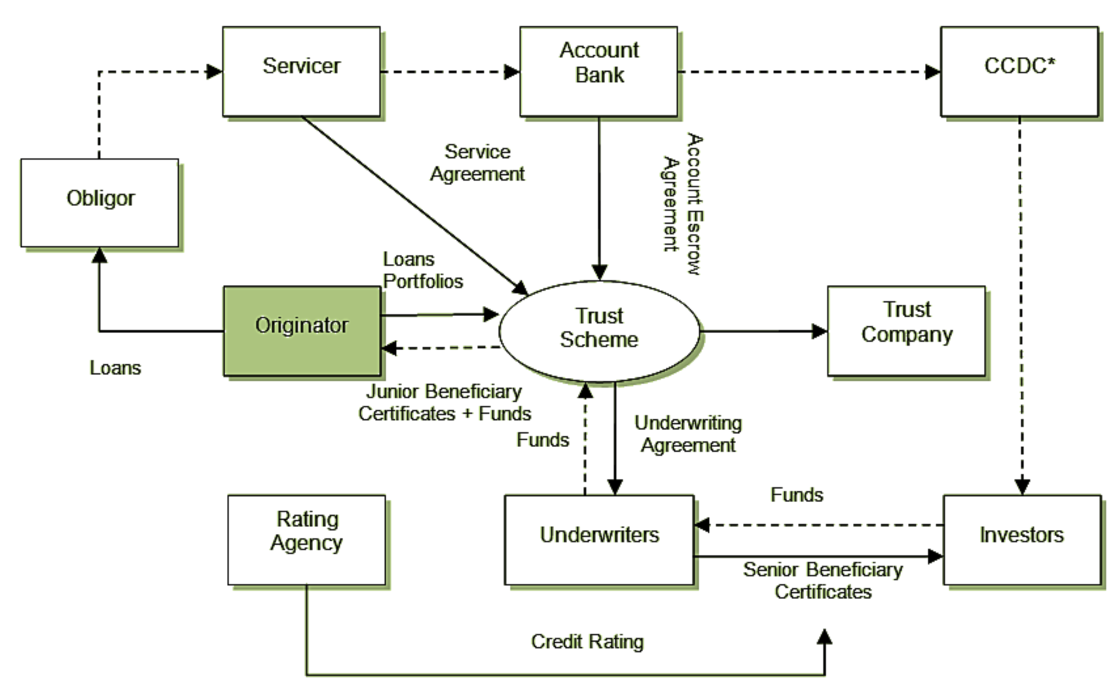
2.1. The SPT Structure

The better known framework is the one promulgated by the CBRC, which involves the securitization of credit assets originated by CBRC-regulated financial institutions (for example, commercial banks, financial leasing companies and auto-finance companies). This typically involves the entrustment of certain credit assets to a special purpose trust, which will form the basis of the receivable pool backing the issuance of ABS in the PRC National Interbank Bond Market (the "**NIBM**"). For the purposes of this article, ABS issued under this framework will be broadly referred to as ABS under the "**SPT Structure**".

The NIBM is not open to retail investors. Rather, it is a closed market available to a group of approximately 10,000 institutional members made up of mainly financial institutions such as commercial banks, securities companies, insurance companies, and various kinds of investment vehicles like mutual funds and pension funds. Among these, commercial banks are the most active participants in the NIBM.

Under the SPT Structure, an originator entrusts "*credit assets*" to the trustee of a special purpose trust which issues ABS in the form of multi-tranche trust certificates. The following PRC regulations are relevant:

- the Administrative Measures on Pilot Projects for Securitization of Credit Assets Procedures, jointly issued by PBOC and CBRC on April 20, 2005;
- the Measures for the Supervision and Administration on Pilot Securitization Projects of Credit Assets of Financial Institutions, issued by CBRC on April 20, 2005;
- the Notice on Relevant Matters Concerning Further Expanding the Pilot Securitization of Credit Assets, jointly issued by CBRC, PBOC and the Ministry of Finance on May 17, 2012;
- the Circular on Further Regulating Risk Retention by Originators in Credit Asset Securitization jointly issued by CBRC and PBOC in December 2013; and
- the Circular Concerning the Filing Process of Securitization of Credit Assets, issued by CBRC on November 20, 2014.



*CCDC refers to China Central Depository & Clearing Co., Ltd.

SPT Structure – at a glance

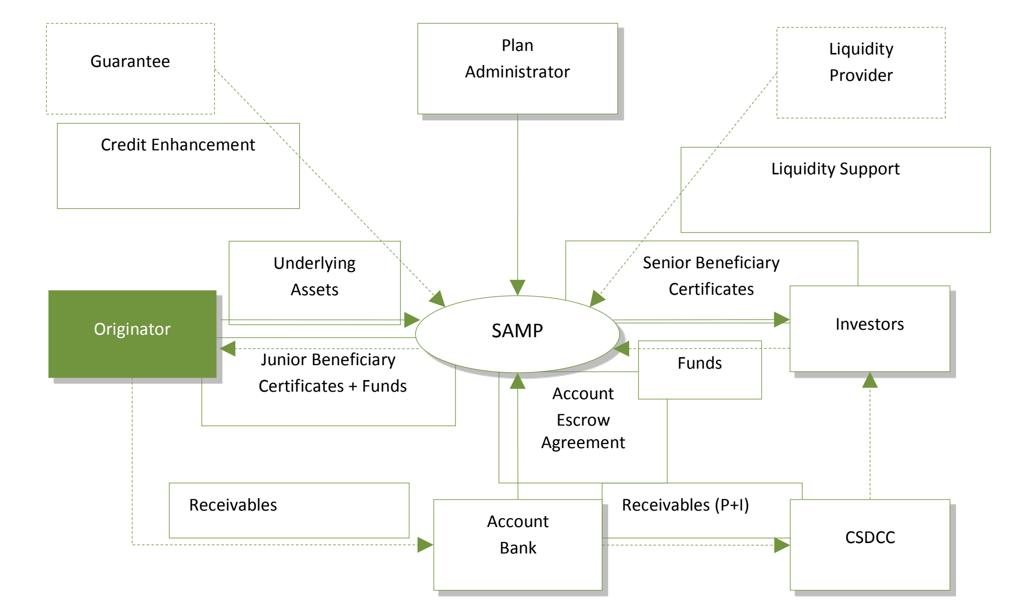
Originators	CBRC regulated financial institutions, including: (a) commercial and policy banks; (b) urban and rural credit unions; and (c) other financial institutions which are regulated by the CBRC such as auto finance companies, asset management companies, finance lease companies and finance companies.
Assets to be securitized	"Credit assets" – this is not clearly defined but includes corporate loans, mortgage loans, auto loans and lease receivables. The Pilot Notice extended eligible financial assets to include agricultural industry loans, credit card receivables and local government loans.
Regulatory approvals / registrations	PBOC and CBRC. CBRC approval process was waived for 27 commercial banks in early 2015.
Originator skin-in-the-game rules	The originator is required to retain no less than 5% of the total exposure credit risks of underlying assets by way of "horizontal slice" or "vertical slice". The "horizontal slice" requires the originator to hold part of the junior tranche with a total nominal value of no less than 5% of total issuance size. The "vertical slice" requires the originator to hold, in addition to at least 5% of the junior tranche, a similar proportion of each senior class notes, such that the total risk retention by the Borrower is no less than 5% of the total issuance size; All the notes invested by the originator for this risk retention requirement should be held-to-maturity.
Trustee issuer	Must be a licensed PRC trust company.
Investors	Members of the NIBM – commercial banks, finance companies, trust corporations, credit unions, mutual funds and securities companies. The Pilot Notice enlarged the possible scope of institutional investors and non-banking institutional investors to insurance companies, securities investment funds, enterprise annuities and national social security funds. Foreign investors including QFII, RQFII, foreign central banks and monetary authorities, clearing banks for cross-border RMB settlement in Hong Kong and Macau and overseas participating banks for RMB settlement of cross-border trade are allowed to trade in bonds in the NIBM (including ABS) after obtaining approval by the PBOC.
Single investor cap	40 per cent for banking institutions.
Rating	All the tradable tranches other than the junior tranche must be rated by at least two credit rating agencies. There is no minimum rating requirement for those tranches.

2.2. The SAMP structure

The second framework is the specified asset management plan framework promulgated by the CSRC (the "**SAMP Structure**"). This framework is technically broad enough to cover credit assets generated by all corporate entities (involving CBRC regulated financial institutions), however, in practice, ABS issuances adopting the SAMP structure have been limited to assets originated by non-financial institutions, such as independent leasing companies, toll operators, e-commerce platforms and telecom service providers. ABS adopting the SAMP Structure can be freely traded in the Shanghai/Shenzhen Stock Exchange.

The SAMP Structure involves a specific asset management plan ("**SAMP**") established pursuant to the *Administrative Provisions on the Asset Securitization Business of Securities Companies and Subsidiaries of Fund Management Companies* ("**SAMP rules**") which were published by the China Securities Regulatory Commission ("**CSRC**") in 2014.

A securities company or a subsidiary of a fund management company, as an asset manager, will offer and launch a SAMP to investors who subscribe units of difference tranches under such SAMP. The offer can be done by the securities company itself or by another distribution agency (e.g. other securities companies, commercial banks and other institutions approved by the CSRC). Upon the closing of offering, the SAMP (acting through the securities company as asset manager) will use the funds to purchase underlying assets. The cash flow generated from the acquired underlying assets will fund the interest and principal payments. The launch of the SAMP is subject to registration and filing with the Asset Management Association of China. Upon the closing and subject to the further registration with the Shanghai Stock Exchange and/or the Shenzhen Stock Exchange, the units of the SAMP can be traded on the stock exchange market.



*CSDCC refers to China Securities Depository & Clearing Corporation Limited.

SAMP Structure – at a glance

Originators	Theoretically covers all types of institutions. So far, all the market precedents involve non-financial institutions.
Underlying assets	Receivables (including trade receivables), credit assets, trust beneficiary rights, infrastructure toll rights and real estate.
Regulatory approvals / registration	Registration with the Asset Management Association of China.
Originator skin in the game	None
Trustee issuer	Not applicable.
Investors	Qualified investors, including individuals, legal entities, organizations and other entities approved by the CSRC.
Single investor cap	No
Rating	No mandatory requirements.

2.3. Quasi-securitizations with cross-border structures

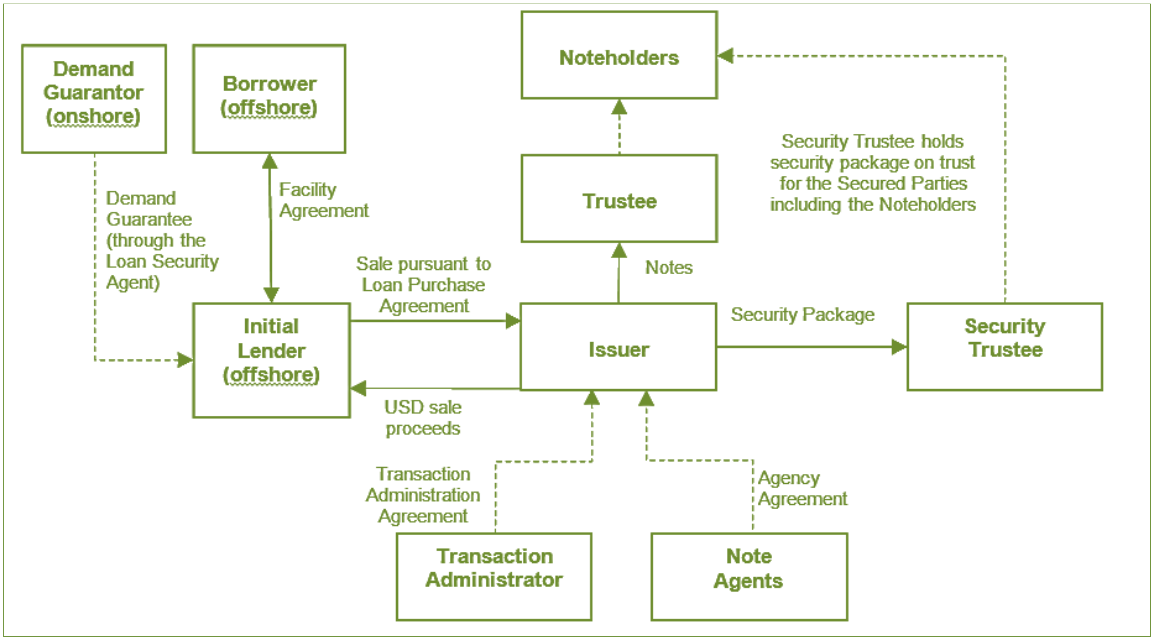
Cross border quasi-securitizations involving PRC-based credit support first came into the market towards the end of 2013. These structures fall outside of the existing securitization framework in the PRC as they are made up of mostly offshore elements, and involve the repackaging of secured offshore corporate loans owed by offshore subsidiaries of PRC corporates.

The only PRC connection is that these offshore loans are backed by onshore credit support in the form of a letter of credit or demand guarantee issued by an onshore branch of a major PRC bank. The loans are then repackaged into rated notes which are listed on a major stock exchange. Due to the onshore credit support given in connection with the loan, the notes usually have a rating equivalent to the credit rating of the onshore credit support provider.

This structure translates to lower all-in borrowing costs for offshore subsidiaries of PRC corporates, and also allows financial institutions to offload such loans on their books to the debt capital markets.

Another attractive feature of this structure is that no PRC licensing requirements apply to any offshore financial institution arranging such a deal, given that most elements are offshore. As such, offshore financial institutions are able to pocket most of the arrangement fees for putting together such deals.

To date, King & Wood Mallesons has been involved in virtually all of such deals that have been successfully launched in the market.



Cross-border single loan repackagings – at a glance

Arrangers	Usually financial institutions with existing PRC corporate clientele wishing to raise funds offshore.
Underlying assets	Offshore corporate loan owing by an offshore subsidiary of a PRC corporate, backed by onshore letter of credit.
Regulatory approvals / registration	Depends on structure. In most cases, no SAFE approval is required.
Originator skin in the game	Since cross-border repacks are not regulated by CBRC/PBOC, no such requirements apply.
Trustee	Generally a securitization conduit established in an offshore tax haven (e.g. Cayman Islands).
Investors	Since this is a cross border issuance, subscribers are generally offshore based investors.
Single investor cap	No
Rating	No mandatory requirements.

3. Recent market trends

3.1. Asset types

Corporate loans are the dominant asset type in PRC securitizations, making up well over 75% of total issuance in the PRC market. This is driven in part by the need for Chinese banks to manage their balance sheets pursuant to the implementation of tougher capital adequacy requirements under Basel III. More recently, CLOs in the PRC market also tend to include risker assets, such as non-performing municipal loans, loans to small-medium enterprises, as well as internet-based microfinancings. It seems unlikely that such CLO's will appeal to offshore investors, largely because of the lack of transparency in the quality of the underlying assets.

Other types of securitized assets in the PRC market include residential and commercial mortgages, lease receivables and auto loans. In particular, auto-loan securitizations have been on the rise on the back of increasing demand for auto vehicles (China's is also the world's largest market for new vehicles). Some of the latest deals involving Volkswagen and Nissan have western-style credit enhancement features, making the structure more palatable to offshore investors buying in through QFII's.

3.2. Key structural features in recent PRC securitizations

As mentioned above, we see an increasing number of domestic securitization offerings with built in western-style structures. These are in part driven by rating agency requirements and regulatory developments.

No offshore elements

To date, all PRC securitizations have been purely domestic deals involving onshore parties only. There have been a couple of cross-border deals which are asset-backed loans or loan repacks involving onshore credit support, but there have been no true cross border ABS as yet. Cross-border ABS structures have yet to take-off in the PRC due to (a) the lack of cross-border ABS legal framework; and (b) the current withholding tax regime.

Static receivable pool

PRC securitizations generally involve a static pool of presently available receivables. This feature is largely driven by legal considerations, due to uncertainty over the true sale treatment of future receivables.

Reserve Account Requirements

The latest structures have more stringent reserve requirements. For some of the new auto-loan securitizations, we've seen multiple reserve accounts to cover liquidity, tax, appointment of back-up servicers, and set-off risk. Reserve amount requirements invariably increase with the breach of each downgrade threshold.

Servicer downgrade mechanics

To address counterparty risk relating to the servicer of the receivables, most securitizations have varying downgrade triggers. The servicing obligations of the servicer will become more onerous following any downgrade of its credit rating (e.g. more frequent obligation to "sweep" all collections from existing collection accounts to a segregated bank account of the trustee) leading to an outright transfer of the underlying credit asset.

Clean-up call

Originators under PRC auto-loan receivables typically have a right to buyback all securitized receivables if the receivable pool balance falls below 10% of the original pool balance that was securitized. This is common feature for credit-card and auto-loan receivable securitizations in the region.

Skin-in-the-game/Risk retention

For securitizations using the SPT structure, it is a regulatory requirement for originators to retain an amount not less than 5% of the overall credit exposure, in the form of junior tranche subscription (or otherwise combined with other senior tranche subscriptions).

3.3. Rating

Under existing rules, PRC securitizations using the SPT structure and listed on the NIBM are required to be rated by 2 different rating agencies – one appointed by the Originator, and another independent rating agency. The qualified rating agencies in the PRC market are set out below.

List of domestic rating agencies in the PRC

- China Credit Rating Co., Ltd;
- China Chengxin International Credit Rating Co. Ltd (in partnership with Moody's Investors Service);
- China Lianhe Credit Rating Co., Ltd (in partnership with Fitch Ratings);
- Dagong Global Credit Rating Co., Ltd;
- Golden Credit Rating International Co., Ltd; and
- Shanghai Brilliance Credit Rating & Investors Service Co., Ltd (in partnership with S&P).

Rating considerations

PRC rating agencies generally use similar rating criteria as major international credit rating agencies, such as Fitch, Moody’s, and Standard & Poor’s. The framework for analyzing structure finance transactions would cover:

- the legality, validity and enforceability of the transaction structure;
- credit performance of the underlying assets (e.g. history, performance, eligibility criteria, static/revolving pool);
- tranching and over collateralization;
- liquidity support, reserve accounts, priority of payments and expense cap; and
- counterparty risk (e.g. right to set-off/withhold, commingling risk, backup service providers, replacement triggers).

3.4. Recent deal list

KWM worked on the following recent ABS issuances:

No.	Originator	Type
1.	CCB 2005 - 1 RMBS Securitization	Residential Mortgage Loan
2.	Cinda 2006 - 1 NPL Securitization	NPL
3.	CCB 2007 - 1 RMBS Securitization	Residential Mortgage Loan
4.	GMAC-SAIC AFC 2008 - 1 Retail Auto Loan Securitization	Auto Loan
5.	CCB 2008 - 1 NPL Securitization	NPL
6.	GMAC-SAIC AFC 2012 - 1 Retail Auto Loan Securitization	Auto Loan
7.	SAIC FINANCE 2012 - 1 Retail Auto Loan Securitization	Auto Loan
8.	Huarong 2014 -1 Restructured Loans Securitization	CLO (Restructured Loans)
9.	Bank of Ningbo 2014 - 1 CLO Securitization	CLO
10.	Dongfeng Nissan AFC 2014 - 1 Retail Auto Loan Securitization	Auto Loan
11.	Volkswagen AFC "Driver" 2014 - 1 Retail Auto Loan Securitization	Auto Loan
12.	Citic Bank 2014 - 4 CLO Securitization	CLO
13.	Bank of Shunde 2014 - 1 CLO Securitization	CLO
14.	BOCOMM Leasing 2014 -1 Securitization	Lease Receivables
15.	Bank of Qingdao 2014 -1 CLO Securitization	CLO
16.	Bank of Communications 2014 - 2 CLO Securitization	CLO
17.	Bank of Shanghai 2014 - 2 CLO Securitization	CLO
18.	GMAC-SAIC AFC 2014 - 1 Retail Auto Loan Securitization	Auto Loan
19.	Bank of Hangzhou 2014 - 1 CLO Securitization	CLO
20.	Bank of Beijing 2014 - 2 CLO Securitization	CLO

21.	Huarong Leasing 2014 - 1 Securitization	Lease Receivables
22.	Bank of China 2014 - 2 CLO Securitization	CLO
23.	HSBC China 2015 - 1 CLO Securitization	CLO
24.	SCB China 2015 – 1 CLO	CLO
25.	Bank of Ningbo 2015 - 1 CLO Securitization	Lease Receivables
26.	Ningbo 2015 -1 CLO	CLO
27.	GMAC-SAIC AFC 2014 - 1 Retail Auto Loan Securitization	Auto Loan

4. Participation in the PRC securitization market

4.1. Offshore Financial institutions

For offshore financial institutions looking to participate in the PRC securitization market, the key roles would be that of (a) originator; (b) underwriter; and (c) financial advisor. As PRC licensing requirements would apply to the first 2 roles, foreign banks have traditionally limited their involvement in onshore securitizations to purely financial advisory work, leaving domestic banks to be involved in the originator and underwriter roles.

More recently, we've seen onshore subsidiaries/JV's of foreign banks attempting to take on the originator and underwriter roles. Examples would include J.P. Morgan First Securities Co., Ltd.'s role as lead underwriter in the CLO Securitization involving Bank of Ningbo in 2014-2015, and HSBC China's and SCB China's roles as originator in the repackaging of a portfolio of their respective onshore corporate loans in 2015.

Roles for an onshore subsidiary/JV of an offshore financial institution (SPT Structure)

Originator	• Theoretically, yes. The originator must be a CBRC regulated entity. • Limited to the onshore assets available to the originator. Onshore credit assets held by foreign-invested financial institutions only represent a fraction of the total credit assets held by all PRC banks.
Underwriter	An underwriter must be a financial institution that meets the following conditions: • registered capital shall not be less than RMB 200 million; • relatively strong capabilities in distributing bonds; • qualified professionals engaging in the bond market business and bond distribution channels; • no material illegal activity and violation; and • other conditions as required by the PBOC.

Financial adviser	Yes. This is not a regulated activity requiring a specific license.

Roles for an onshore subsidiary/JV of an offshore financial institution (SAMP Structure)

Originator	Generally no.
Underwriter/Distribution Agent	Yes - Commercial banks are qualified to be engaged in the distribution during the offering of the SAMP.
Asset Manager	No – because so far only securities companies or subsidiaries of fund management companies with an asset management business license can be an asset manager.
Financial adviser	Yes. This is not a regulated activity requiring a specific license.

4.2. Offshore investors

Based on PRC rules and regulations existing as of May 2015, direct foreign investment into an onshore special purpose trust (as a holding vehicle for securitized assets) is not permitted. This is because regulatory approval is required for cross-border capital flows of this type, and regulatory approval is generally not given for direct offshore investment into an offshore trust.

QFII and RQFII are the main ways for foreign investors to participate in the onshore capital market. But the investment scope of QFII and RQFII, in the context of PRC securitizations, are limited to the purchase of fixed income products traded on the NIBM, and exclude investments in OTC trust units. Therefore, QFII and RQFII are not practical legal channels for foreign investors to make investments into onshore trust and this remains a potential area for future reform.

5. Legal issues in PRC Securitizations

5.1. Legal true sale

A securitization transaction involves a true sale of the assets from an originator to a purchaser (usually a special purpose vehicle or a trust). Different requirements apply for legal true sale (which feeds into the insolvency claw-back analysis) and accounting true sale (which feeds into the off-balance sheet treatment analysis). The analysis here is limited to achieving a legal true sale.

The legal true sale analysis is different for the securitizations using the SPT Structure and the SAMP Structure. As explained below, the SPT Structure would provide a much more robust true sale analysis.

True sale analysis for the SPT Structure

Under the SPT Structure, the credit assets initially owned by the originator are entrusted to a trustee (usually a regulated professional trust company) pursuant to a special purpose trust. Under PRC law, after the underlying assets are entrusted to a trustee pursuant to payment of a purchase price, the rights of the trustee as transferee in good faith will generally remain unaffected by subsequent insolvency proceedings involving the originator.

There are some key exceptions to this general principle under PRC insolvency law and trust law:

(a) under article 31 of the PRC Bankruptcy law, the bankruptcy administrator has the right to rescind any transactions relating to an originator's assets occurring within 1 year of acceptance of a bankruptcy petition relating to that originator, if such transaction falls within the following categories:

- a transfer without consideration;
- a transfer at an obviously unreasonable price;
- a guarantee of unsecured debts;
- a payment of debts which are not due; and
- the abandonment of a claim; and

(b) under article 15 of the PRC Trust law, if an originator is the only beneficiary under a trust, then the entrusted assets will form part of the originator's bankruptcy estate, even if the originator became bankrupt after the entrustment of the aforementioned assets.

While there has been no legal precedent in the PRC market of an originator under a securitization becoming insolvent, the general consensus in the PRC securitization industry is that the existing trust framework is sufficiently robust to confer upon a trustee good title to any entrusted assets even after the insolvency of the originator.

True sale analysis for the SAMP Structure

The SAMP in comparison envisages a contractual transfer of credit assets from an originator into a specific asset management plan ("**SAMP**"). The SAMP is not a separate legal entity from the originator and such transfer merely contractual (as opposed to being an entrustment).

Accordingly, investors in securitizations under the SAMP Structure are unlikely to receive a clean true sale legal opinion usually expected in traditional securitizations.

5.2. Bankruptcy remoteness

Traditional securitization structures contemplate the transfer of assets to either (a) a bankruptcy-remote securitization SPV; or (b) a trust. As there is no specific PRC legal framework for the establishment of a securitization SPV, the use of a trust is the preferred approach. The SPT Structure specifically contemplates this trust approach.

SPT Structure – Insolvency of Trustee

While a special purpose trust created under the SPT Structure is not, by itself, a separate legal entity, trust assets are generally held and managed by a trustee on behalf of the special purpose trust, so impact of the insolvency of this trustee is an important consideration as well.

In this regard, article 15 of the PRC Trust law provides confirms that where a trustee (in its personal capacity) becomes insolvent, the trust assets held by it will not form part of the trustee's insolvent estate.

SAMP Structure

The analysis is much weaker for the SAMP structure. As mentioned above, the SAMP is not a separate legal entity, but rather, a separate asset management plan established by the originator.

5.3. Perfection requirements for a transfer of receivables

Under PRC law, there is a distinction between (a) the perfection of a sale of receivables as between the seller (i.e. the originator) and the purchaser (i.e. the trustee under a special purpose trust); and (b) the perfection of a sale of receivables as between the purchaser and the underlying obligor. Generally speaking, for (a) above, there are no specific perfection requirements prescribed by law, and for (b) above, notice to the underlying obligor is required pursuant PRC contract law. Failure to perfect the assignment under (b) above will not affect the validity of a transfer of receivables under (a) above.

Transfer from Originator to a Special Purpose Trust

For securitizations using the SPT Structure, the execution of the trust agreement documenting the transfer of the credit assets from the originator to the special purpose trust is generally sufficient to ensure that such transferred credit assets will be beyond the reach of the originator's other creditors.

There is no precedent of an originator trying to sell the same pool of receivables to two different persons, and if this happens, the general view is that priority will be determined by the time of execution of the trust agreement (i.e. the first in time prevails).

Perfection as against the underlying obligor

In relation to a transfer of receivables, article 80 of PRC Contract Law requires notice to be given to the underlying obligor for such transferred receivables. If such notice is not given, the transfer will not be effective as against the underlying obligor – from a practical perspective, this simply means that the buyer of such receivables will not be able to sue the underlying obligor directly to recover amounts owed without first notifying the underlying obligor of such transfer.

For the avoidance of doubt, failure to give notice will not invalidate the transfer of receivables as between the seller and the purchaser of such receivables – and there is judicial precedence confirming this point.

Perfection as against the underlying obligor – current market practice

The common market practice for PRC securitizations is that notice to the underlying obligor is not given until the occurrence of certain trigger events, such as a downgrade or insolvency of the originator or servicer. Prior to the occurrence of such trigger event, the originator of the receivables will also be the servicer of the receivables (i.e. responsible for collections under the receivables, with a duty to transfer such receivables to the purchaser at regular intervals).

This tracks the general market practice for most securitization deals in the region (Australia, Korea, Hong Kong, Singapore), where notice to the underlying obligor is given upon the occurrence of certain “perfection events”.

5.4. Transfer of security interest connected to a receivable

In most securitization transactions involving the sale of receivables which are secured by underlying assets (e.g. auto loans, residential mortgage loans), the nature of such underlying assets will determine the additional perfection formalities, if any, that is required to transfer the security interest.

Auto-loan receivables

In relation to a securitization of auto-loan receivables, PRC Property Law provides that the underlying vehicle mortgages are transferred together with the sale of the auto-loan receivables. However, for the transferred mortgages to be effective against bona fide third parties, they need to be further registered as a first-ranking mortgage by the Originator with the relevant vehicle management bureau. The specific registration requirements differ based on the applicable provincial or city-level regulations.

Based on existing market practice, most PRC auto-loan securitizations do not involve the registering of new first-ranking mortgages in relation to the securitized auto-loan receivables due to the operational burden of such registration process. Instead, investors rely on over-collateralization and mandatory repurchase undertakings from the originator for protection.

Residential mortgage loans

In contrast, for residential mortgage loans, the transfer of an existing property mortgage cannot be automatically transferred with the sale of the relevant residential-mortgage loan; the existing property mortgage will need to be re-registered in favor of the purchaser of the loan receivable. In this regard, the market practice in the PRC securitization market is not to require any such re-registration on the date of the asset transfer. Rather, re-registration is only necessary upon the occurrence of certain trigger events, such as a downgrade in the credit rating of the originator.

5.5. Commingling risk

In securitization deals, it is common for the originator to double up as the servicer in relation to the securitized receivables. Often such collections will be commingled with collections from other receivables in the originator’s own collection account. Under PRC law, in the event of the originator’s insolvency, such commingled amounts will form part of the originator’s bankruptcy estate.

It is not always practical for an originator to establish segregated collection accounts for securitized receivables. This is because such an arrangement will involve the originator implementing new payment arrangements, and notifying the underlying obligors of the same, which can be an operational hassle. Based on existing market practice, commingling risk is mitigated by the following operational arrangements:

(a) the originator making arranging for periodic transfers of collections from the originator's own collection account to the purchaser's (i.e. the trustee's) account. The time period between such periodic transfers will be shortened if the credit rating of the originator falls below a certain threshold; and

(b) an additional requirement for the originator to send notify each underlying obligor to pay directly to the purchaser if the originator's credit rating falls even further, or if the originator becomes insolvent.

6. Considerations for future reform

Despite the explosive growth of ABS issuances in the PRC, perhaps it is noteworthy that existing laws only permit a limited class of investors to subscribe for ABS issuances adopting the SPT structure – this closed group mainly consists of domestic banks, insurance companies, securities companies and mutual funds.

To the extent that credit assets originated by a commercial bank are repackaged into ABS sold to other commercial banks on the NIBM, there is no true transfer of risk – rather, the situation seems to be more akin to an exchange of risk within the banking industry, with no real offloading of risk to the capital markets.

The most common proposals for future reform of the PRC securitization industry are summarized below.

6.1. Single securitization framework

There have been calls for a streamlined securitization framework for all companies, thus removing the SPT/SAMP distinction. This would bring uniformity in addressing common legal risks (e.g. commingling, true sale, transfer of security) across all securitization offerings within the PRC.

6.2. Withholding tax treatment

One key stumbling block to cross border issuances of domestic issuances is the existing 10% withholding tax in place for offshore remittance of interest collections. Removal of this tax for securitization transactions would go some way in encouraging cross-border issuances to offshore investors.

6.3. Direct foreign investment

Existing regulations do not permit direct foreign investment into an onshore trust holding securitized assets. Also, existing routes for foreign investors to access domestic ABS issuances are overly restrictive.

To facilitate cross border foreign investments into an onshore trust holding securitized assets, it will be up to PBOC promulgate specific regulation allowing this (existing regulations do not permit this), subject to some basic requirements that the investment is made in RMB and the investment scope and plan of the trust is mainly focused on asset securitization. By denominating investments in RMB, this would not attract the additional regulatory oversight on SAFE and provide a more direct and attractive route for direct foreign investment in domestic ABS issuances.

IV. State of securitization UK, US and rest of Asia (ASIFMA)

1. US and Europe

Regulatory Perspective

The United States and Europe have seen numerous regulatory developments enacted or proposed over the past few years in response to the financial crisis. These developments had and continue to have a significant impact on the regulatory treatment of securitization transactions.

US

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act"), from July 21, 2010 has been the major regulatory reform impacting securitization transactions but continues, till today, to require substantial ongoing rule-making in order to implement its specific provisions. The aim of the Dodd-Frank Act was to define broad goals but then delegate specific regulatory reform to the various United States financial regulatory agencies.

EUROPE

There were many new regulations in Europe over the recent years, which impacted deeply the markets, including securitizations (especially ABS). The Basel II and III Accords, various capital requirements including the latest Capital Requirements Directive and Capital Requirements Regulation (together the "CRD"), the Credit Agency Regulation (the "CRA Regulation"), the Alternative Investment Fund Managers Directive (the "AIFMD") and the Solvency II Directive are some of those regulations. Some had positive impacts: Solvency II helped to reduce the capital requirement for ABS, Basel risk weighting proposal helped to increase the RW for ABS.

Market

US

The securitization market in the US represents 60% of the global market today. The crisis impacted heavily the volumes of US securitization which felt from over EUR 2.0 trillion in 2007 to EUR 915.8 billion in 2008 (inclusive of ABS, CDOs, Agency MBS and Non-Agency CMBS/RMBS) and have since recovered to EUR 1.07 trillion in 2014. All the asset classes (but private label MBS) showed an impressive rebound.[6]

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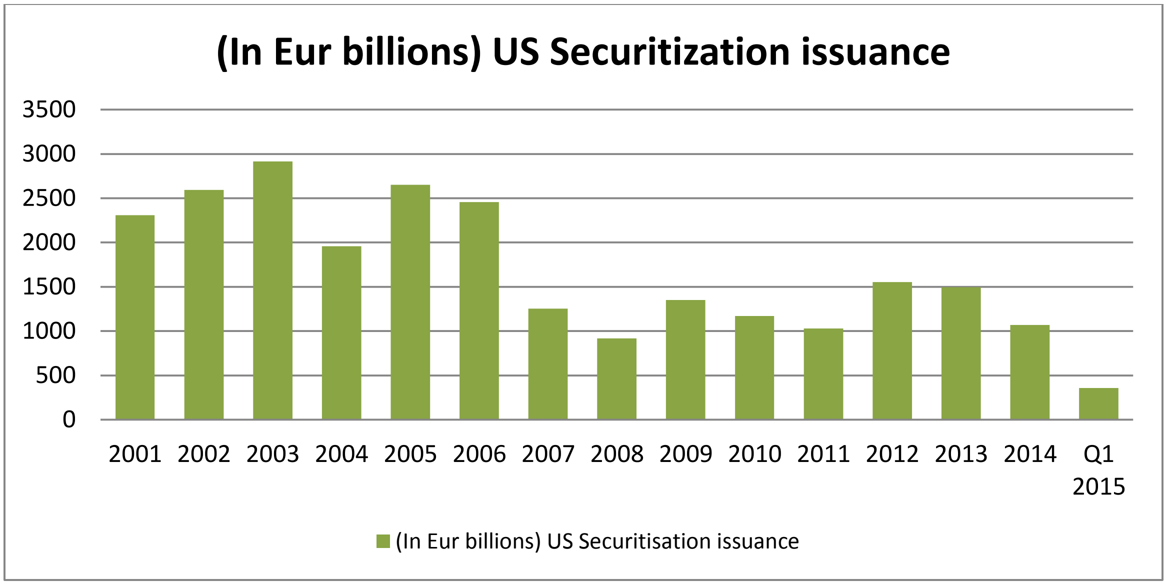
[6] http://www.imf.org/external/pubs/ft/sdn/2015/sdn1501.pdf
http://uk.practicallaw.com/1-501-1955/
https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_impaired_eu_securitization_marketen.pdf



(Source: SIFMA/AFME Securitization Quarterly Report)

Europe

The securitization market in Europe was rather undeveloped till the late 1990s. Since then, there has been a significant increase in securitization activity. Many of the securitization products widely used by the financial industry across the world have been developed in the UK. The UK securitization is the largest market in Europe.

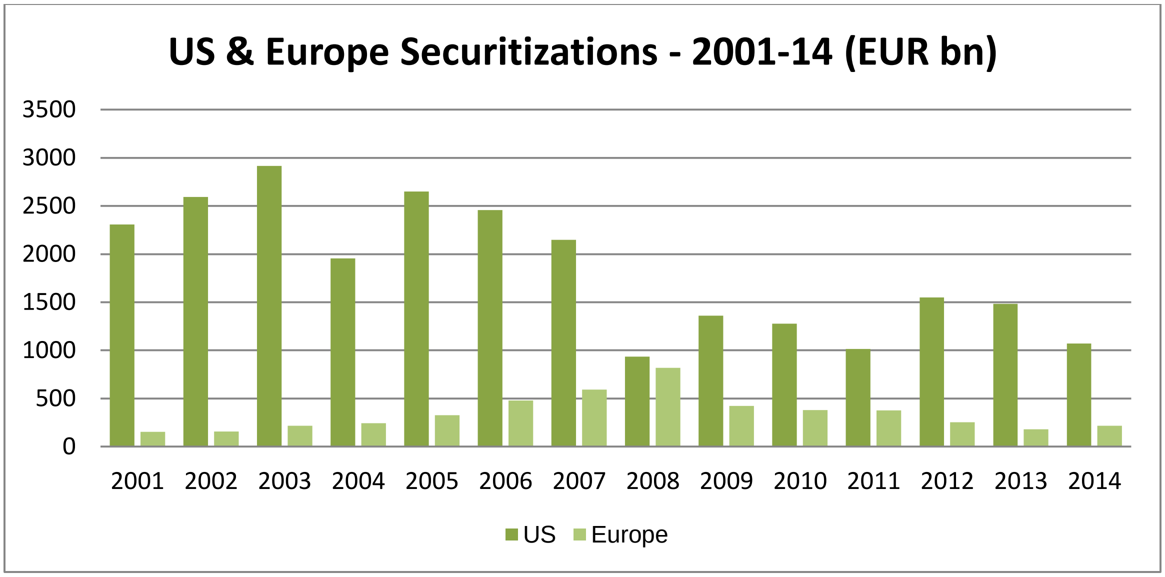
The financial crisis in Europe made securitization plunge from EUR 819 billion in 2008 to EUR 423 billion in 2009 and steadily decreased to EUR 180 billion in 2013, before finally recovering at EUR 216 billion in 2014. It is interesting to highlight that European securitizations have held up very well through and since the crisis in both credit and pricing terms. European policymakers are making every effort to revive the market, since the rationale for securitization and the benefits it provides remain strong.[7]

Europe saw a general spread compression which turned the investors to look for yield and hence looking to deals with better pricing such as peripheral paper, CLOs, CMBS, non-prime RMBS, etc.

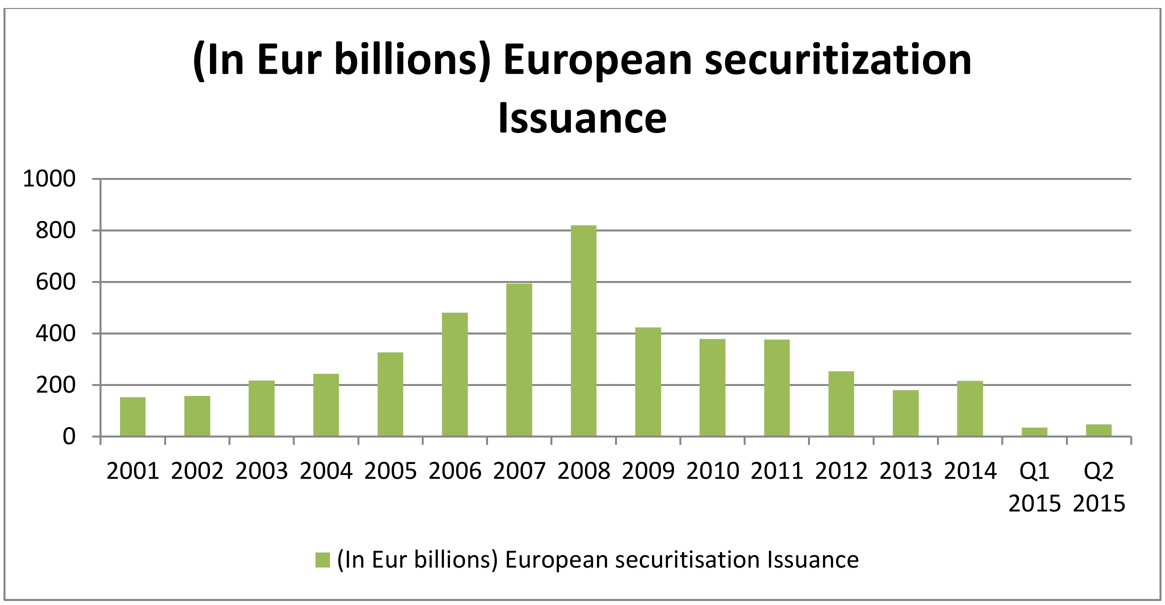
In Europe, there are mainly three types of investors interested in securitization: a) institutions without deep multiple funding sources (e.g. challenger/smaller banks, non-bank FI's and PE houses off the back of acquisitions) or that have a strategic reason to securitize (i.e. showing liquidity for an IPO or deleveraging), b) peripheral jurisdictions, c) arbitrage players (e.g. CLO managers or bank underwritten CMBS), and d) the auto sector where spreads are very tight.[8]

[7] AFME / SIFMA / http://www.john-crosby.co.uk/pdfs/CCCO_WhyDoBanksSecuritize.pdf

[8] http://www.asifma.org/uploadedFiles/Events/2014/Structured_Finance_Conference/Singapore_ASIFMA20Conference_Sent.pdf



(Source: SIFMA/AFME Securitization Quarterly Report)



(Source: SIFMA/AFME Securitization Quarterly Report)

2. Rest of Asia

In Asia, the regulatory and market frameworks governing securitization are relatively nascent. Domestic securitization markets are more active relative to their cross-border counterparts. Cross-border issuance, which is only a fraction of US and European issuance, dropped sharply post 2008 as the market for CDOs (which accounted for the bulk of Asian issuance pre-2008) virtually shut down.

It is worth noting that, as long as Asian companies will be able to obtain cheap funding in their local capital markets, they will not look to cross-border securitization deals.

2.1. South Korea

Regulatory Perspective

South Korea' Securitization really took off in the aftermath of the financial crisis in 1998 with the passage of the Asset-Backed Securitization Act (ABS Act) on 16 September 1998 to facilitate the restructuring or disposal of non-performing loans of financial institutions and the Korea Housing Finance Corporation Act (KHFC Act) enacted on December 31, 2003 to facilitate securitization of mortgage loans and student loans by the Korea Housing Finance Corporation (KHFC).It enables KHFC to issue two types of mortgage-backed instruments: MBS and Covered bonds. The ABS act allowed the establishment of a "True Sale" framework, and the legislation enabling the issue of covered bonds, has led to considerable development of the Korean cross-border ABS market.

In South Korea, Securitizations are usually performed within the framework of the ABS Act (ABS Act securitizations, which include securitizations by the KHFC) or outside the ABS Act (non-ABS Act securitizations).

The South Korean securitization market has expanded since the introduction of ABS transactions but the size of the non-ABS Act securitization market remains much larger than the ABS Act securitization market. This is mainly due to the fact that ABS Act securitization involves certain procedural requirements under the ABS Act, such as registration of a securitization plan. Thus, unless the deal is looking for special benefits under the ABS Act, such as more lenient perfection requirements; most securitizations are non-ABS Act securitizations.[9]

It is worth noting, while covered bonds in South Korea are based on the current Korean covered bond legislative framework, RMBS issued by the Korea Housing Finance Corporation (KHFC) is effectively similar to a covered bond. Since investors in covered bonds have recourse to both the issuer and the underlying "cover pool" of assets, these structures are attractive from the viewpoint of international investors. For the moment, KHFC has issued RMBS in the domestic markets and has also issued USD-denominated covered bonds in the international market. These deals, according to ratings agency Moody's, are comparable to other Korean RMBS transactions. [10]

9 http://uk.practicallaw.com/6-381-1640?source=relatedcontent

10 https://www.moodys.com/research/Moodys-upgrades-KHFCs-two-covered-bonds-to-Aa1--PR_269744

Market

The Securitization domestic market in South Korea has developed into one of the most sophisticated in Asia-Pacific. Today, South Korea has one of the most developed securitization frameworks in Asia. Cross-border Securitization transactions remain quite low because originators can source local currency funding by issuing bonds and because the Korean government has encouraged Korean companies to reduce their foreign exposure due to the volatility of the global economy.

In Korea, the big players in the securitization market are mostly financial institutions. They are very sensitive to funding cost for securitization and structured finance deals which are quite costly and require a lot of work. That is why clients tend to not seek structured deals unless they see significant benefits on those.[11]

Central bank liquidity schemes and retained securitizations have not been common in South Korea. Securitization is concentrated mostly in residential mortgage-backed loans, credit card receivables, auto instalment loans and loan receivables relating to real estate project finance. The mezzanine tranches of CLOs with investment grade ratings are also particularly attractive for Korean insurance companies who have guaranteed high payouts on insurance policies and other products sold to investors in the past.

New securitization products have been introduced recently in Korea such as the securitization of franchise trade receivables and there is also an increasing demand for allowing derivatives structures, such as synthetic collateralized debt obligations (CDOs).

Asset-backed securities (ABS) were first issued in Korea in 1999 and grew rapidly till 2001 but then saw a decreasing trend till 2008. It was relatively less affected by the crisis than other products, which explains the good figure in 2009 but declined again in 201o due to the suspension of P-CBO issuance for bond market stabilization funds. It rebounded in 2011 and we can see a growing trend till now.

Asset-backed Commercial Paper (ABCP) is divided in two classes in Korea: ABCP issued pursuant to the ABS Act and the ones issued pursuant to the Commercial Code.

Perspectives

The ABS Market in Korea developed thanks to the government which enabled the legal framework (ABS act & other acts) to remove the existing legal obstacles to securitizing assets. The regulatory authority also helped to promote rapid, but not excessive, market development.

In Korea, the ABS Act provides the means for properly regulating the ABS market but additional measures to supplement the current rules and regulations on ABS are required following the financial crisis.

Some concerns have been raised over the fact that ABCPs are not governed by the ABS Act as they are largely issued based on mortgage loans, it is highly likely that the risks of the depressed real estate sector will pass through into other sectors, undermining the stability of the overall

[11] http://www.iflr.com/Article/3093937/How-recent-legislative-proposals-impact-South-Korean-structured-finance.html

financial market. Therefore, in order to stabilize the market, additional regulatory measures against the ABCP are also required.

The government plans to take appropriate steps to improve the market system in order to prevent asset-backed securities risk from spreading throughout the market, while also promoting the future growth of the asset-backed securities market. As asset-backed securities are an effective and stable tool for corporations and financial institutions to finance capital and an attractive investment vehicle for investors, the government plans to continue taking supportive measures for the promotion of the asset-backed securities market.

In addition, the government needs to come up with comprehensive legislation for governing a wide range of securitized products, including asset-backed securities and credit derivatives, in order to minimize the side effects of asset securitization, while maximizing its proper functions in the financial market.

Korea has also enacted Covered Bond legislation (See Chapter 5 below). Some significant amendments done in the Trust Act of Korea in 2012 also gave more flexibility for trusts to issue bonds and debt instruments.

The main issue for foreign investors in Korea is the foreign exchange controls. On one hand it might appear onerous and burdensome to foreign investors but on the other hand it contributed to the stability of Korean financial industry which economy is highly affected by the volatility of the foreign exchange market.[12]

2.2. Singapore

Regulatory Perspective

Based largely on the English common law system, the development of a legal framework for securitization in Singapore gained momentum in the late 1990s, as the government sought to develop an active secondary bond market. In 1999, the Singapore government enacted regulations that permitted individuals to invest their pension funds in bonds with a minimum Standard & Poor's rating of 'A'[13]. These regulations governing eligible investments for the Central Provident Fund (CPF), Singapore's pension system, increased the universe of eligible investments for those contributing into the CPF and also conferred advantages on local issuers. This created a very favorable atmosphere for securitizations in Singapore, as issuers could now take advantage of both a favorable regulatory framework, coupled with a class of investors with an affinity for a natural long position in Singapore Dollar denominated instruments.

Specific legislation governing securitization in Singapore was enacted by the MAS in September 2000, when MAS Notice 628 (as amended in 2006 & 2007) was promulgated.[14]

Strong internal managerial control and the establishment of systems for managing and monitoring risk, in relation to asset-based transactions are critically important and regulated

12 http://www.iflr.com/Article/3093937/How-recent-legislative-proposals-impact-South-Korean-structured-finance.html

13 S&P Ratings Services

14 MAS Website http://www.mas.gov.sg

bodies must obtain the approval of the MAS before entering into ABS transactions. Some of the key disclosure requirements to investors include the following:[15]

- The securities do not represent deposits or liabilities and are subject to investment risk
- The seller of the securities does not stand behind the capital value or performance of the assets/securities – except in certain cases, for permitted credit enhancement or liquidity facilities and
- The SPV is independent from the bank (although related directors are permitted in certain circumstances).

The regulations also set out the criteria for a clean sale of assets to a SPV, for capital adequacy purposes. Some of the key features are[16]:

- The requirement that there should be a full transfer of risk and reward – essentially, the beneficial interest in the assets must be transferred.
- The transfer of the assets may not contravene any restriction in the documents relating to the underlying assets.
- There can be no obligation to repurchase assets, other than if there has been a breach of representation or warranty.
- The seller must not be obliged to make a market in the securities.
- Any rescheduling arrangements entered into by the servicer must bind the SPV.

Additionally, the seller must obtain legal and accounting opinions that the regulations have been complied with. The regulations also define the requirements for banks acting as servicers, credit enhancements, liquidity facilities and the relevant capital treatments.

Among other important features of the legal framework governing Singapore securitizations, the assignment of actionable claims requires that the debtor be served a legal notice under sec. 4 (6) of the Civil Law Act. As a consequence, if debtor notification is to be avoided, assignments in Singapore will have to be “equitable assignments”. Another consequence is that not being the legal owner of the receivables, the securitization SPV cannot bring claims in its own name and would have to depend on the originator.[17]

Finally Goods and Services Tax (GST) is not applicable on the transfer of debt securities/securitized instruments/notes. Only the assignment of mortgages attracts stamp duty while the securitization of other receivables will not be subject to this duty. [18]

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[15] IFLR.com – article by Clifford Chance dated Nov. 2nd 2000

[16] IFLR.com – article by Clifford Chance dated Nov. 2nd 2000

[17] http://www.vinodkothari.com

[18] http://www.vinodkothari.com

Market trends and developments

Commercial Real Estate (CRE) has been the mainstay of securitization activity in Singapore, with the bulk of the structures consisting of on-balance sheet MBS, CMBS and REITS. The fist securitization structures date back to the late-1990s, when real estate receivables were securitized, with the funding for this structure carried out through the issuance of long-dated fixed rate mortgage-backed bonds. Other securitization structures include credit card receivables, asset-backed CP and loans. The REIT (Real Estate Investment Trust) structure has been especially popular, with the Capita Mall and Ascendas REITs among the more well-known of the several REITS that have been listed on the SGX. Another unique feature of the securitization market in Singapore is the buy-back option embedded in the asset backed securities (ABS)[19]. This feature allows the originator to retain a contingent claim on the upside potential of the asset price.

Up to 2006-07, in the years prior to the Global Financial Crisis (GFC), securitizations in Singapore were focused on structures that incorporated Structured Investment Vehicles (SIVs) and conduits. Post the GFC however, the market went into hibernation for a period of about 5 years till 2013, when the need for funding diversification on the part of issuers looking at more efficient capital structures, has become the key driver. Instead of having a mix of straight loans, bonds and equity, issuers are looking at securitization to diversify their sources of funding as banks run up against single-borrower limits and as they review their risk-weighted assets amid tighter banking regulations.[20] Yet another difference from the past is the structuring of deals aimed at a local investor base (thus shielding them from currency fluctuations – a key consideration at a time of increased currency volatility) and the carrying out of more private placements – thus shielding investors from mark-to-market risks.

2.3. India[21]

Regulatory Perspective

The financial sector in India has witnessed a series of reforms and changes since the early nineties, when the government initiated a series of economic reforms, among which was the removal of a number of hurdles standing in the way of foreign direct and indirect investment in India. The need for a legal framework on securitization was also recognized at this time, when various committees tasked with looking into the development of securitization pushed for the establishment of a legal architecture governing this key asset class.

The development of securitization in India received a major boost over the 2002-05 period, following the enactment of the Securitization and Reconstruction of Financial Assets & enforcement of Securities Interest Act (SARFAESI), 2002 ('the Act') 1. The Act encompasses the areas of: securitization of financial assets; reconstruction of financial assets; recognition to any security interest created for due repayment of a loan as security interest under the Securitization Act, irrespective of its form; banks and financial institutions have the power to

19 Sing, Tien Foo and Ong, Seow Eng and Sirmans, C. F., Asset-Backed Securitization in Singapore: Value of Embedded Buy-Back Options. Journal of Real Estate Finance and Economics, Vol. 27, No. 2.)

20 http://JakartaGlobe.beritasatu.com

21 Sources: ASIFMA, ICRA

enforce the security without intervention of the courts; setting up the Central Registry for registration of the transaction of securitization, reconstruction and creation of security interests.

On specificity and problem with Securitization in India is that securitizations follow a trust structure i.e. the assets are transferred by way of sale to a trustee, who holds it in trust for the investors. In this situation, a trust is not a legal entity in law but it is entitled to hold property that is distinct from the property of the trustee. Therefore, the trust performs the role of the special purpose vehicles (SPV).

A number of clarifications and guidelines were published by the RBI over the last decade, such as:

In early 2006, the RBI issued guidelines on regulatory capital treatment for securitization which had an adverse impact on the securitization market. While the RBI guidelines did provide a robust regulatory and institutional framework for the orderly development of the securitization market in the long term, these guidelines did eliminate some of the incentives for securitization in the short term. This led to reduction in issuance volume.

In Feb 2013, the RBI clarified the taxation of securitization trusts.

In May 2013, the RBI broadened the scope of limits under 'Agriculture' and 'Micro and Small Enterprises (MSEs)' sections of the overall PSL classification, which would have also contributed to an extent towards banks' ability to source greater PSL volumes on their own and reduce dependence on securitization route to meet their overall PSL targets.

The RBI, in July 2013, put released guidelines for reset of credit enhancement (CE) in securitization transactions for banks, which was subsequently extended to cover NBFCs as well in the guidelines of March 2014. Pursuant to these guidelines, some amount of reset of CE in securitization transactions is possible (prior to these guidelines, no reset in CE was permitted), subject to certain criteria being met.

In May 2013, the RBI broadened the scope of limits under 'Agriculture' and 'Micro and Small Enterprises (MSEs)' sections of the overall PSL classification, which would have also contributed to an extent towards banks' ability to source greater PSL volumes on their own and reduce dependence on securitization route to meet their overall PSL targets.

Market

India is one of the first countries in Asia Pacific to develop a securitization market, with the first transactions as early as the 1990s.

In the early 1990s, securitization was essentially a device of bilateral acquisitions of portfolios of finance companies. Back then, securitization of auto loans remained the mainstay throughout the 1990s. The securitization market in India has then developed till the 2000s and spread into several asset classes – housing loans, corporate loans, commercial mortgage receivables, future flow, project receivables, toll revenues, etc. that have been securitized.

The growth in the Indian securitization market has been largely fueled by the repackaging of retail assets and residential mortgages of banks and Financial Institutions. This market has existed since the early 1990s but really matured, only post-2002, following the passage of the SARFAESI Act, as pointed out earlier. Over the next three years, growth in RMBS, MBS and CDOs fueled the rapid growth of the securitization market through 2005, as new classes of investors and issuers gained confidence in the stability of and prospects for the further development of the market. Furthermore, investor familiarity with the underlying asset classes, stability in the performance of past pools and the relatively short tenor of issuances also helped boost the market.

After a brief dip in 2006, caused by the tightening of RBI capital requirements, strong growth in ABS and CDO volumes boosted the Indian securitization market through the first half of 2009, when the after effects of the global financial crisis did have a negative impact. Even so, the absence of transactions involving complex derivatives and CDS in the Indian context meant that Indian securitization volumes id stay relatively robust, in the immediate aftermath of the financial crisis.

The structured issuance volumes have grown considerably in the last few years in India. ABS is the largest product class driven by the growing retail loan portfolio of banks and other FIs, investors' familiarity with the underlying assets and the short maturity period of these loans. The MBS market has been rather slow in taking off despite a growing housing finance market due to the long maturity periods, lack of secondary market liquidity and the risk arising from prepayment/repricing of the underlying loan.

Within the auto loan segment, the car loan segment has been more successful than the commercial vehicle loan segment, mainly because of factors such as perceived credit risk, higher volumes and homogenous nature of receivables. Other types of receivables for which securitization has been attempted in the past include property rental receivables, power receivables, telecom receivables, lease receivables and medical equipment loan receivables. Revolving assets such as working capital loans, credit card receivables are not permitted to be securitized.

During FY2014 (Financial Year 2014), the overall securitization market (including rated bilateral transactions) in India shrunk further by 5% over the previous year, in value terms. The number of transactions was also lower by 4% in FY2013 than that in the previous fiscal. While the number and volume of ABS transactions declined by about 14%, the number of RMBS transactions more than doubled in FY 14, (an increase of 75% in value terms).

Trend in securitization issuance by value, in INR millions, per Financial Year (FY)

	FY 10		FY 11		FY 12		FY 13		FY 14	
	Amount	**Share**	**Amount**	**Share**	**Amount**	**Share**	**Amount**	**Share**	**Amount**	**Share**
ABS	214,970	50%	218,190	69%	273,440	71%	272,300	90%	235,040	82%
RMBS	62,540	14%	50,290	16%	76,800	21%	30,250	10%	52,960	18%
Total Retail Securitization	**277,510**	**64%**	**268,480**	**84%**	**350,240**	**92%**	**302,550**	**100%**	**288,000**	**100%**
LSO	145,810	34%	44,410	14%	22,170	6%	-	-	-	-
Others	7,870	2%	5,360	2%	6,350	2%	-	-	-	-
Overall total	**431,180**	**100%**	**318,250**	**100%**	**378,760**	**100%**	**302,550**	**100%**	**288,000**	**100%**
Growth	*-20%*		*-26%*		*19%*		*-20%*			*-5%*
Avg. Deal size	*2,310*		*2,000*		*1,740*		*1,510*			*1,490*

(Source: ICRA
Financial Year 2013 - 14, i.e. April 1, 2013 to March 31, 2014)

Perspectives

Nowadays, India's budget is prioritizing growth over deficit reduction and India's growth is expected to remain stronger than the global average and more robust than the median for similarly rated sovereigns. India will have long-term funding needs which could be provided by the securitization market to finance housing, infrastructure and urbanization projects.

India will implement the Goods and Services Tax in April 2016 which is expected to lead to scale and productivity gains, and direct cash transfers for subsidy delivery could increase the efficiency of the social welfare system, although they will not reduce subsidy spending.

Legal framework for securitization is at a nascent stage in India as it is restricted to certain institutions namely, banks and financial institutions only. The Act is certainly a futuristic step and well-deserved appreciation must be given towards the step. It is hoped that in future more and more transactions may be included under the Act so that the market matures and reach to an advanced stage like UK or US, as this process will help in growth of the economy.

The Act is an important step by Indian government as it provides the much needed legal sanctity to securitization by recognizing the securitization instrument as a security under the SCR Act. Development of the market for securitization in India will need efforts of the Central Government, State Governments, Reserve Bank of India and Security Exchange Board of India (SEBI) has permitted mutual funds to invest in these securities. To galvanize the market Foreign Institutional Investors (FIIs) can also be allowed to invest in securitized debt within certain. FIIs are already familiar with these instruments in other markets and can, therefore be expected to help in the development of this market. However the measures taken in India are still incomplete and more dedicated efforts would be necessary for a robust growth of asset securitization market in India.

There are several issues facing the Indian Securitization Market such as:

- Stamp Duty: In India, stamp duty is payable on any instrument which seeks to transfer rights or receivables. Therefore, the process of transfer of the receivables from the originator to the SPV involves an outlay on account of stamp duty, which can make securitization commercially unviable in states that still have a high stamp duty. Few states have reduced their stamp duty rates, though quite a few still maintain very high rates ranging from 5-12 per cent. To the investor, if the securitized instrument is issued as evidencing indebtedness, it would be in the form of a debenture or bond subject to stamp duty, and if the instrument is structured as a Pass Through Certificate (PTC) that merely evidences title to the receivables, then such an instrument would not attract stamp duty. Some states do not distinguish between conveyances of real estate and that of receivables, and levy the same rate of stamp duty.

  SEBI has suggested to the government on the need for rationalization of stamp duty with a view to developing the corporate debt and securitization markets in the country, which may going forward be made uniform across states as also recommended by the Patil Committee.

- Foreclosure Laws: Lack of effective foreclosure laws also prohibits the growth of securitization in India. The existing foreclosure laws are not lender friendly and increase the risks of MBS by making it difficult to transfer property in cases of default.

- Taxation related issues: There is ambiguity in the tax treatment of mortgage-based securities, SPV trusts, and NPL trusts.

- Issues under the SARFAESI Act: A security receipt (SR) gives its holder a right of title or interest in the financial assets included in securitization. This definition holds good for securitization structures where the securities issued are referred to as pass through certificates. However, the rationale fails in the case of pay through certificates with different classes of primary and secondary rights to the cash flow. Also, the SARFAESI Act has been structured such that SRs can be issued and held only to Qualified Institutional Buyers (QIBs). There is a need to expand the investor base by including NBFCs, non-NBFCs, private equity funds, etc.

- Legal Issues: Investments in PTCs are typically held-to-maturity. As there is no trading activity in these instruments, the yield on PTCs and the demand for longer tenures especially from mutual funds is dampened. Till recently, Pass through Certificates (PTC) were not explicitly covered under the Securities Contracts (Regulation) Act, definition of securities. This was however amended with the Securities Contracts (Regulation) Amendment Act, 2007 passed with a view to providing a legal framework for enabling listing and trading of securitized debt instruments. This will bring about listing of PTCs which in turn will support market growth.

- India market is negatively impacted by restrictions around minimum holding period (MHP), minimum retention requirement (MRR), etc. If an issuer wants to provide credit enhancement, the requirement of MHP and MRR should be removed as their commitment to the ongoing performance of the facility is established through the credit enhancement.

- The taxation structure should be changed from distribution tax at SPV level to taxation in the hands of investors as the current regime is not beneficial for banks/NBFCs who have been the dominant investor class in the securitization market.
- The development of an efficient securitization market can also be extended to local municipalities and authorities, providing them with a cheaper source of capital to fund infrastructure projects by securitizing the assets, and selling the bonds to investors to fund its development. India needs to expand and increase access to its existing securitization markets.

Securitization requires a stable and predictable operating environment. India must establish clear legislative, legal and regulatory guidelines for market participants, incentivize the development of high quality data for proper risk assessment, and increase foreign participation.

(Sources: ASIFMA, ICRA)

V. Development of Covered Bonds (Fitch Ratings)

1. Motivation for covered bonds

Covered bonds historically have been viewed as a purely European funding product, but its reach has extended from Europe over the last five years. A number of countries such as Australia, Chile, Canada, New Zealand, Panama, Singapore, South Korea and Turkey have now established their own covered bond markets. The expansion of the covered bond market has somewhat been driven by events of the global financial crisis that limited liquidity and funding where wholesale debt markets were effectively shut. The European covered bond market was credited with remaining open at the height of the crisis or depending on the country, being the first one to re-open, allowing for banks to access funding albeit heavily supported by the European Central Bank. This experience prompted other regulators and governments, whose banking systems were impacted by the shutdown of funding markets during this time, to take a closer look at the issuance of covered bonds for their domestic banks.

Fitch Ratings has observed covered bonds being used to facilitate long term funding for financial assets, such as residential mortgages and public sector loans. They have also been used to fund commercial real estate mortgages, ship loans and, less frequently unsecured SME loans as well as aircraft financings. According to Fitch's investor surveys, historically covered bond investors have generally preferred cover pools consisting of the former, more familiar assets. But as quantitative easing measures in Europe continue to force down yields on the typical mortgage and public sector European covered bonds, the interest of investors in different assets and diversification into other countries could be rooted in the likely pick up in yields for them. These events may also drive innovation regarding the type of assets and liability structures used in programs. We have already seen this with the introduction of a pass-through liability amortization and the inclusion of SME loans in cover pools for some programs in Europe, characteristics that are more customary in securitization transactions. Fitch believes if the issuance of covered bonds becomes a permanent feature of Asia, it would not be surprising to see other assets being refinanced, reflecting the diversity of assets that are originated by Asian banks.

The introduction of a covered bonds framework into new jurisdictions involves motivation of market participants, regulators and lawmakers to enact a set of rules where a covered bond market can establish and provide a functional, reliable and consistent funding tool. This is essentially why regulators elsewhere including Asia are looking at covered bonds as an alternative contingent funding tool for their markets. However Asia's banking market fundamentals are very different from Europe's. At first glance it is not clear why covered bonds would be considered attractive as a funding channel given the observed highly liquid Asian banking system, mainly funded through deposits and local term funding. Such funding is currently relatively cheap domestically in most countries of Asia, with the use of cross-border funding programs being less significant compared to more developed markets. In Fitch's view, these factors may not incentivize banks or regulators to use covered bonds, even if covered bonds would be generally cheaper than existing funding, as the set up costs of the programs are often quite expensive. But as observed in recent times, markets can change and liquidity may not always be available in the same volume and price, in the event of an economic downturn or contagious crisis of confidence. Should regular funding markets become dislocated for these reasons, it can become more difficult to set up a functioning and reliable covered bond market in a limited time period where banks are in stress, unless there is support from regulators and governments.

As an example, in December 2010, the Australian government sought to set up a covered bond market to help banks accessing funding where markets become dislocated, and avoid the need for the government to step in to guarantee bank debt to secure their liquidity. While the Australian banks weathered the crisis better than others, the Australian government had been guaranteeing billions in bank debt during the global financial crisis. Given the banks' then high reliance on cross border wholesale funding, it was the government's and market's view to set up a framework as soon as possible to allow the banks to use covered bonds to diversify their funding, allowing them greater flexibility in tapping markets during a period of stress.

This response was already in place across the Tasman in New Zealand, where the banks' regulator, Reserve Bank of New Zealand (RBNZ), had encouraged the use of covered bond programs from as far back as 2008. While the issuers were supervised by the RBNZ, their covered bonds were initially issued under contractual arrangements not subject to any specific regulatory regime. It wasn't until December 2013 that the government passed formal covered bond legislation, under which existing programs could be registered and monitored. This legislation opened up the New Zealand market to a greater array of covered bond investors, who otherwise could not invest in New Zealand issued covered bonds.

2. Development of Asian covered bonds

The first Asian covered bond originated from South Korea in 2009 through a structured covered bond issued by Kookmin Bank under the Korean Securitization Act. The transaction was a single issuance secured by mortgage assets as well as credit card receivables. In 2010, Korean Housing Finance Corporation (KHFC) issued its first covered bond under their program governed by the Korean Housing Finance Act. Each covered bond issuance from KHFC is backed by a distinct pool of mortgage assets, each purchased from an originating bank. Using the KHFC program, participating Korean banks could access covered bond funding without needing a separate program.

In 2012, the South Korean authorities proposed the Covered Bond Act which coincided with the government's concern regarding high household debt. Along with the Financial Services Commission (FSC), it hoped that covered bonds, representing long term fixed rate funding, would enable the banks to offer longer term fixed rate mortgages. This measure was to help curb the risk of households with high short term debt suffering an interest rate shock. It was intended that covered bonds would help banks to manage interest rate risks as well as enabling the banks to meet the FSC's fixed rate mortgage target. The Covered Bond Act along with the presidential decree was enacted on April 15, 2014.

Singapore's Monetary Authority (MAS) also started developing a covered bond framework in 2012 with the release of a proposal to introduce rules to allow covered bond issuance by Singaporean incorporated banks. Unlike the legislative route taken in South Korea, MAS preferred to issue regulation under the existing Banking Act. The regulation for covered bonds outlined in MAS notice 648 was issued December 2013. This notice was further updated in June 2015 to clarify parts of the original notice and providing banks with the flexibility to segregate the cover assets through either an asset-owing special purpose vehicle (SPV) or by way of a declaration of trust. This last change was to enable to banks to comply with specific obligations relating to the Central Provident Fund (CPF) for mortgage assets where the borrower elected its use.

Each country has approached the formation of a covered bond framework differently. But it is evident they both have taken what exists in other frameworks and used the best of those parts that suited their requirements. In the case of South Korea, the framework followed the integrated issuance template based on the German Pfandbriefe model. By contrast, Singapore's MAS used a principles based approach on the guidance for covered bond issuance, asset segregation method, monitoring and eligible assets, yet it allowed issuers to commercially agree aspects of the structure and contractual obligations. In both cases, the regulators looked to restrict covered bond issuance via a 4% limit, relative to total banks assets, on the amount of assets that can be encumbered by the programs. Compared to other countries with a similar cap, this is on a par level with the issuance cap set in Canada, and is lower than Australia and New Zealand, where caps are 8% and 10% respectively.

Finally, June 2015 saw DBS Bank Ltd in Singapore and Kookmin Bank in South Korea as the first issuers for each country to launch a program under their countries' respective covered bond frameworks, both of which were rated by Fitch. It is expected that other issuers will follow in each country. Whether other Asian countries start to develop their own covered bond framework will certainly depend on the success of these two markets, with further issuance from more banks along with investors continuing to support them.

3. General features of covered bonds frameworks and structures that Fitch rates

Covered bond frameworks can either be based on contractual obligations, principles based regulation, specific legislation or a combination of the three. The frameworks are developed by regulators using existing laws or implementing dedicated covered bond legislation to protect the claims of investors over the cover pool. Some bank resolution regimes, such as Europe's Bank Recovery and Resolution Directive (BRRD), explicitly exempt covered bonds from bail-in. Outside Europe, the proposals and approach so far has been mixed, driven by the regulators' view of the importance of the product.

Segregation of assets pledged as part of a cover pool can be effected through a transfer to an asset-owing SPV acting as guarantor of the issued bank debt, or via a legal ring-fencing mechanism which uses an asset register, or a transfer to a specialized covered bonds issuing subsidiary. Certain risks of set-off, commingling and claw back can be addressed in either case via specific legislation or through contractual obligations set in program documentation. The validity and enforceability of these features in mitigating leakage risk is generally confirmed through a legal opinion. The types of assets eligible for regulated covered bond programs are often set at the framework level. For programs not regulated or where no eligible assets are specified in the framework, the cover assets will be defined in the program documents. The most common assets included in cover pools are residential mortgages and public sector assets. Cover pools are generally homogeneous pools, although several frameworks allow to mix residential and commercial mortgage loans in the same cover pool, as in Germany or Spain, or to mix mortgage and public sector assets, as in France and Sweden. Unlike non privileged swaps which banks execute in the normal course of business, privileged derivatives are intended to survive the insolvency of the issuing bank, and continue to provide hedging of the cover assets or the covered bonds after recourse has switched from the issuer to the cover pool as a source of payment.

The main form of credit enhancement in covered bonds programs comes from the fact that the cover assets value exceeds the covered bonds outstanding. Minimum overcollateralization (OC) for covered bond programs may be stipulated at either the framework level and/or at the program level. In general mandatory regulatory OC would not be sufficient to support a high rating on covered bonds, so it is usual to find programs holding more OC to support these higher rating levels. Although issuers are expected to maintain a certain level of OC at any time, the valuation of the cover assets compared to the covered bonds can be conducted periodically, at least quarterly. The asset valuation method may be outlined in specific regulation or defined in the program documentation. The asset valuation calculation ensures that there are sufficient assets in the cover pool to repay the liabilities outstanding should recourse switch to the cover pool from the issuer.

The use of the demand loan feature in covered bond programs has been increasing in asset-owning SPV covered bond programs located outside of Europe. It is seen on programs from Australia, Canada, New Zealand and Singapore. The demand loan allows the issuer to vary the amount of voluntary OC in the program over and above that required under the asset valuation test. In general, the repayment of the demand loan ranks ahead of covered bond investors and therefore cover assets secured by this demand loan will not be available for the benefit of covered bond investors. How the demand loan is repaid can impact the liquidity of a covered bond program when it needs it the most. Mostly the demand loans are repaid in kind with mortgages upon a trigger of the mandatory repayment. Where the program only foresees the repayment of the demand loan in cash, this would limit the program's ability to repay upcoming maturities, as it could necessitate further liquidation of cover assets after the recourse has switched from the issuer to the cover pool as a source of payment.

Due to the asset and liability mismatches inherent in most covered bond programs, their documentation and, in some cases, applicable frameworks will contain features to mitigate short term liquidity risk and principal payment risk. For instance, a regulatory liquidity provision may require issuers to hold on an ongoing basis, as part of the cover pool, cash or liquid assets covering cash flow shortfalls scheduled over the next 180 days. Other protection can be in the form of extendable maturities periods on bonds, allowing for a work out period of up to 12 months following the maturity date, or pre-maturity tests on hard bullet bonds, which if breached, typically if the short term rating of the issuer falls below a certain threshold, leads to the cash-collateralization of upcoming maturities that are due within a 12 month period. The time given to liquidate assets where needed and the level of liquidity of the cover assets determines whether a program can successfully overcome the asset and liability mismatches.

Typically public sector assets are considered the most liquid, only needing up to a few months for liquidation, whereas residential and commercial mortgages are generally thought to be less liquid depending on the type of assets secured by the mortgages. Invariably the liquidity of these assets is dependent on investors' appetite for these assets. The most common method of asset liquidation in programs where recourse has switched to the cover pool would be by way of asset sale. Some jurisdictions make it possible for the asset owning entity to repo cover assets directly to a central bank or to issue new covered bonds that can equally be repo-ed to obtain short term liquidity for an upcoming maturity. Almost all frameworks allow for liquid assets up to a certain percentage of the program total assets or bond outstanding, for example 5-15% of the cover pool or as part of a separate reserve.

Ongoing monitoring on covered bond programs is performed by a cover asset monitor, who is an independent third party appointed in accordance with the framework or program documents. Their responsibilities can include ensuring the covered bond program is being operated in a manner that is in accordance with the program documents, error checking of calculations required to be performed by the issuer and confirming that the issuer is in compliance with the requirements of the regulatory framework. Having the cover asset monitor provides investors an additional layer of protection, in addition to the regulator's oversight of the issuer.

Should recourse switch to the cover pool, either the framework and/or the program documents will outline who is responsible and the requirements for the management of the cover pool. In countries such as Germany, Ireland and South Korea among others, the legislative framework is very prescriptive on the appointment and duties of a cover pool administrator. Most frameworks however are less prescriptive on this topic and as a result it is generally left to either the interpretation of the regulations and/or reliance on contractual obligations in the underlying program documents. While the transfer to an administrator is practically untested, it is believed the sooner an administrator can act, gain access to required systems and manage the cover assets, the better the outcome will be for investors. Delays in the appointment of an administrator, the capacity and accessibility of systems and whether duties can be carried out as required without any legal or outside impediment as well as interaction with the relevant authorities will all impact the repayment of covered bonds after recourse shifts to the cover pool.

VI. The Ratings Framework for Securitization (MOODY'S)

1. Key Factors in Assessing Credit Risks in Asian Emerging Market Securitization Transactions

Assessing credit risks in Asian emerging market securitization transactions requires a thorough understanding of the specific legal and regulatory requirements, the quality of the underlying assets, and the structural features of the securitizations.

In this context, this article highlights the issues and challenges in assessing the credit risks in such transactions[22] in China specifically and other emerging markets in Asia generally. It further provides an overview of Moody's approach to analyzing the key risk elements and the mechanisms that Moody's uses to determine rating levels.

Legal and regulatory considerations

One of the most fundamental legal considerations when assessing structured finance transactions is whether the transactions have sufficient bankruptcy remoteness protection, including the establishment of a bankruptcy remote special purpose vehicle and protection from the potential bankruptcy of the transaction sponsors or sellers.

Asset ring-fencing, asset transfer and security perfection are important because transactions must ensure a well-established claim in the collateral, as well as timely enforcement of the collateral that is not subject to a delay owing to the insolvency or bankruptcy proceedings of any transaction parties.

Factors that can reduce the likelihood of an issuer becoming insolvent or bankrupt are extremely important in Moody's assessment of the credit risks of a structured finance transaction. Moreover, legal precedents showing the enforceability and applicability of the bankruptcy remoteness of the issuing vehicle used in securitizations can enhance understanding of these risks. However, in Asian emerging markets, laws and regulations can vary considerably, even across different jurisdictions within the same country.

In China, securitizations issued under the Credit Asset Securitization (CAS) program, the framework regulated by the People's Bank of China and the China Banking Regulatory Commission (CBRC) for issuing securitizations within the banking system, must have a special purpose trust (SPT) structure. The use of an SPT incorporated under the Trust Law provides stronger protection for the ring-fencing of the entrusted assets from the bankruptcy estate of a defaulted originator or issuer [23].

However, the securitization of assets outside the banking system in China can also be governed by the Asset Backed Specific Plan (ABSP) framework, which the China Securities Regulatory Commission regulates.[24] ABSP is based on an assignment concept between principal and agent.

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[22] This article focuses on securitization transactions other than transaction categories under structured credits.

[23] See "Further Direction Needed on Bankruptcy Ring-Fencing in China Securitization Transactions," November 19, 2014.

[24] See "Further Direction Needed on Bankruptcy Ring-Fencing in China Securitization Transactions," November 19, 2014.

However, questions remain over how the assets can be ring-fenced. For example, it is unclear how the assets can be separated in the event of the bankruptcy of the project manager.

On the regulatory side, Moody's will assess whether prior regulatory approval of transaction issuance, asset transfer, and security perfection is required, or whether restrictions are present that could affect the ability of the trustee and/or investors to possess, manage or sell the securitized assets. If such regulatory restrictions are evident, Moody's will review how the transaction addresses them without compromising the interests of the investors.

In China, one example is foreign exchange control, which the State Administration of Foreign Exchange (SAFE) regulates. For transactions involving the conversion and transfer of renminbi into foreign currencies to offshore investors, Moody's examines whether SAFE has issued prior approval. Without such approval, there can be no guarantee that the free cross-border flow of principal and interests can be safeguarded for offshore investors. This presents the risks of transferability to the transaction, which is credit negative.

2. Underlying assets - credit risk and availability of data

The credit quality of the underlying assets remains the most important driver of the credit ratings of the securitization notes. Moody's analysis focuses on the probability of default on the assets, the chance of recovery in the event of default, and the uncertainties associated with these default probabilities and recoveries.

This assessment will include a forward-looking examination of macroeconomic conditions and market dynamics, as well as the business strategies and business operations of the sponsor. The assessment will also review historical performance, in particular performance during a period of economic distress. Challenges with respect to the availability of data, and the quality and integrity of the data are also present.

Below are some of the weaknesses in Asian emerging markets that can pose credit risks in securitization transactions:

- Comprehensive historical data on defaults, prepayments and recoveries on the underlying assets may be unavailable; for example, static pool data can be lacking.
- The lack of defaults, default data and a well-tested, transparent bankruptcy and loan workout process further complicate assessing recovery rates on loans.
- The data that originators provide might cover only a relative short time,[25] owing to a short operating history or a change in information technology systems.
- The available data period coincides with strong economic growth; as a result, it does not provide insight into any potential performance deterioration by the relevant receivables during a period of economic distress; in China, for example, a benign macroeconomic

[25] See rating action on Moody's definitive rating to SAIC-GMAC auto loan ABS in China, Rongteng Individual Auto Mortgage-backed Securitization 2015-1, June 2015.

environment has prevailed since the country adopted its open door policy a few decades ago.

- Even data on the underlying assets is available, audit procedures might not be sufficient to ensure its accuracy and reliability; this factor is particularly important for small originators which might not have robust information technology systems and audit procedures.
- Market-wide data on the region, such as a property price index, may also be absent.

When analyzing transactions with the above weaknesses, Moody's needs to compare their performance with that of other developed and emerging markets in order to estimate performance during a distressed period.

As a result, the final model assumptions will be more stressful than the performance observed in the historical performance data. For instance, the default probability and coefficient of variation assumptions in China auto ABS could be higher than those derived from the historical performance of the receivables.

In addition to potential stress of the assumptions, concerns over data quality might also limit the highest achievable rating of the transaction.[26]

3. Operational and counterparty risk

In structured finance transactions, the issuer often has no employees or facilities of its own, and therefore must retain a third party as the servicer which administers the day-to-day operations of the transaction.[27] As a result of this arrangement, the strength of a securitization depends not only on the creditworthiness of the underlying pool of assets, but also on the performance of all third parties in the transaction, such as the servicer, cash manager and trustee. A number of transaction parties may not be rated locally or internationally. A disruption in the performance of any of these parties can hurt the transaction.

For example, the bankruptcy of the servicer could lead to a commingling loss if the servicer has not transferred the collections from the securitization pool to the transaction trust account. In addition, a servicing disruption might weaken collection activities, leading to increased delinquencies, lower recoveries and ultimately, higher losses on the collateral in the securitized pool.

In Asian emerging markets, operational and counterparty risks often present weaknesses in a transaction. For example, a back-up servicing arrangement is absent, or the arrangement is untested. In some Chinese auto loan asset-backed securitization (ABS) transactions, the diversified nature of the collateral pools that characterize many outstanding auto loan ABS transactions highlights the risk of a disruption in servicing and the lack of replacement servicers.

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[26] See "Global Structured Finance Data Quality Evaluation Approach," March 2015.

[27] These operations include routine asset portfolio administration duties, such as determining interest rates on assets, managing the flow of payments from borrower to issuers and collecting late payments. Other responsibilities might include advancing funds to provide liquidity to cover loans in arrears and temporarily reinvesting idle cash in short-term investments.

Some transactions lack upfront, fully-funded liquidity protection, such as a liquidity reserve or a liquidity facility. This may increase the risk of a temporary cash disruption in the case of a disruption in servicing, or the bankruptcy of any other counterparty in the transaction, with some potential adverse consequences for the rated notes. Such a situation could limit the highest achievable rating for the notes. As a result, the credit quality of the original servicer, its parent and parental support is very important in Moody's determination of the highest achievable rating.

Set-off risk will arise if the originator owes reciprocal payment obligations to the underlying obligors and perfection of loan transfer against the obligor is absent. If the borrower can offset the loan it owes to the originator against the obligations due from the originator, set-off risks could be present in the transaction. Deposit-taking originators, such as banks and deposit-taking companies, are prone to such risk.

4. **Structure and credit enhancement**

The structure of the transaction has a significant effect on the risk profile of the issued notes. One key structural element is the allocation of cash flow in the transaction and the priorities of payment, i.e., the payment waterfall. Other structural features – including portfolio substitution; rating triggers components of internal credit enhancement, such as the reserve account; excess spread; and over-collateralization --are also crucial elements of Moody's credit risk analysis.

Auto loan ABS transactions in China have adopted different payment waterfalls, such as:

- full turbo payments[28] in which the transactions will use all principal collections and any excess interest collections for early repayment of the rated notes in a sequential manner, and until the transaction fully repays each class of notes; and
- excess spread to cover principal loss owing to underlying defaults[29].

The degree of protection afforded to investors from the different payment waterfalls can vary drastically.

Korean credit card ABS transactions provide another example of different waterfall structures. The issuer can use collections from the underlying securitization pool to purchase new receivables from the originator during the revolving period. In such cases, a careful examination of the early amortization triggers in revolving deals is important because setting the triggers at different levels could have significantly different effects on the credit profile of the transactions.

5. **Currency and interest rate risk**

In cross-border securitizations, the hedging of currency mismatch is important. In addition to the regulatory approval requirements on currency conversions and transfers, the depth of the foreign exchange market and the volatility of exchange rate movements are also crucial

[28] See "Chinese Auto ABS, Not All Structures Are Created Equal," December 4, 2014.

[29] See "Chinese and Indian Auto ABS: Two Very Different Markets When it Comes to Forms of Credit Enhancement," August 12, 2015.

considerations because trading in the currencies of emerging market economies tends to be illiquid and volatile.

Furthermore, securitization transactions might show the risk of interest rate mismatches due to the use of different interest rate benchmarks or different interest rate reset dates.

In some Chinese securitization transactions, the underlying loans pay fixed-rate interest to the originator. However, the interest rate on some classes of notes might be linked to the benchmark deposit rate that the PBOC sets and which changes in accordance with changes in monetary policy. If deregulation of interest rates occurs in China, which would allow market forces to determine deposit rates, such a mismatch could be amplified.

As a result, Moody's will assume that the future interest rate will move in an unfavorable direction for the originator. For instance, when modeling transactions with underlying assets earning a fixed interest rate against rated notes paying a floating interest rate, we will apply higher floating interest rates during the transaction's term.

In addition, the swaps market of an emerging market economy might not be liquid or deep relative to more mature markets. As a result, there could be a risk for the originator/ issuer in finding replacement swap providers which, in turn, may increase the rating linkage to that of the swap provider.

6. Local and foreign currency country risk ceilings

An additional consideration in assessing the credit risks of Asian emerging market securitization transactions is country risks arising from political, institutional, financial and economic factors either within a particular country or externally. These risks include political instability, conflict risks, and regulatory and legal uncertainty over, for example, the enforceability of contracts.

Other country risks include the risk of government intervention, such as the expropriation or nationalization of local assets, as well as the risk of systemic economic disruption, severe financial instability, currency redenomination under adverse circumstances, and natural disasters.[30]

Moody's further categorizes country risks into the local currency country risk ceiling (LCC) and foreign currency country risk ceiling (FCC). In the case of China, we rate both the LCC and FCC at Aa3.

The LCC captures non-diversifiable country risks, which affect all issuers and assets in a country. Neither local diversification of the portfolio nor credit enhancement can mitigate these ceiling risks. The country risk ceiling therefore indicates the highest achievable rating, whether for a note-level or issuer-level rating, that Moody's can assign to locally-domiciled obligors or structured notes.

The FCC signifies the risk that a defaulting government would adopt a moratorium on the foreign currency debt repayments of domestic issuers. Moratorium restrictions refer to two

[30] See "Local Currency Country Risk Ceiling for Bonds and other Local Currency Obligations," January 20, 2015.

separate risks: restriction on moving foreign exchange offshore (transfer risk) and restrictions on freely converting local currency to foreign currency (convertibility risk). In Korean ABS transactions, the moratorium risk is usually covered by entering into a cross-currency swap with an offshore swap provider. Under such an arrangement, the swap provider will continue to swap the local currency into foreign currency, notwithstanding the imposition of a moratorium.[31]

Securitization Rating Analysis Requires a Blend of Qualitative and Quantitative Analysis

When analyzing a structured finance transaction, Moody's identifies appropriate rating approaches and methodologies based on the asset type, structure and other specifics of the transaction. We then conduct detailed analysis according to the identified rating approaches and methodologies. The entire process involves a thorough examination of both the qualitative and quantitative aspects of the transaction.

The assessment can include a wide range of factors, such as country risk, macroeconomics conditions, the legal and regulatory environment and the industry outlook. Other factors include the company's market position, business profile and strategies, as well as historical asset performance and the outlook for future performance. Moody's also examines the transaction structure and the payment allocation priority.

The examination of the above factors helps us select the inputs for our quantitative analysis. We typically use a cash flow model to calculate the expected loss (EL) and the weighted-average life (WAL) of the rated notes. Moody's calculates a securitization note's EL percentages based on the probability weighted average of the occurrence of losses that the note would sustain under various default scenarios.

Applying a similar calculation on the duration of the note provides the note's WAL. To provide consistent ratings across different asset classes and markets, Moody's typically assigns securitization ratings by comparing the EL, and the WAL of that particular note[32] against Moody's Idealized Cumulative Expected Default and Loss Rates tables. For instance, the EL of a securitization note with a WAL of five years should not exceed 0.16 basis point to achieve a Aaa rating, as per Moody's Idealized Cumulative Expected Loss Rates table.

Using Chinese auto loan ABS as an illustration, Moody's examines both the qualitative and quantitative factors in determining the appropriate inputs for the cash flow model.

These cash flow model inputs include, for instance,

(a) the default distribution[33] and recovery rate of the underlying auto loan pool by referring to historical data and benchmarking with other Asian emerging markets (benchmarking against other emerging markets in Asia is an important consideration as the Chinese auto loans

[31] See "Comparison of Korea and US Credit Card ABS," 28 September 2011.

[32] For long-term notes, the rating assignment has factored in both the default probability and the expected loss of the rated note. For short-term notes, Moody's focuses more on the expected default probability instead of expected losses.

[33] Moody's assumes that the default distribution of auto loan ABS will follow a lognormal distribution; a granular portfolio of homogeneous auto loans generally backs these transactions.

market has not gone through any period of real economic distress,

(b) the capital structure, the application of excess spread and the overcollateralization trigger for switching the payment waterfall according to the structure in Chinese auto loan ABS transactions, and

(c) the commingling loss and payment disruption risks through a thorough assessment of the default risks of the transaction parties, such as the originator/servicer and the account bank. Depending on the merits of the transactions, the assessment on transaction parties might cover their parent companies and their level of support for the relevant transaction parties.

Moody’s will then discuss the model outputs (EL, WAL and other potential outputs, such as the probability of default for the rated notes), together with other quantitative and qualitative factors relevant to the transaction (e.g. legal, operational or counterparty risk, and sovereign risk, etc.) in a rating committee to determine the final rating of the notes.

The “A to Z” of Credit Research on Structured Finance: Please refer to Appendices, page 79.

VII. Taxation Issues in Securitization (Ernst & Young)

Executive summary

Tax neutrality and tax certainty are needed to assist the growth of the Asian securitization market, which presently remains widely untapped. The market would likely grow where securitization transactions can be more accurately priced and rated, thus contributing to the development of an efficient securitization market. Tax neutrality should help in removing the obstacles of additional or accelerated taxation with the result that, both, participants and revenue authorities are neither better nor worse off from a tax perspective. Examples of these types of laws can be found in certain Asian countries (say, Malaysia and Thailand). Additionally, tax certainty for participants is necessary for greater confidence in market outcomes. These objectives (i.e. tax neutrality and tax certainty) may be achieved through comprehensive tax rules or, alternatively, through the issuance of specific tax guidance by the revenue authorities.

1. Taxation of securitization arrangements

To support the growth of the Asian securitization market, tax policy for securitization transactions should be set with the primary objective of achieving tax neutrality, irrespective of the nature of the taxpayer. Tax neutrality means that the same amount of tax should be paid at the same time in a securitization structure as it would otherwise have been paid had the securitization transaction not been entered into. Additional tax costs in a securitization structure are a significant economic disincentive for a securitization market.

In addition, taxpayers (i.e. the different participants in a securitization transaction) should have certainty for the amount and timing of the tax that needs to be paid in a securitisation transaction.

Both tax neutrality and tax certainty need to be considered in both wholly domestic securitization transactions and securitization transactions involving cross border payments that can lead to additional layers of complexity.

This section of the report considers the tax policy objectives (neutrality and certainty) for securitization transactions, and the current status of taxation of such transactions in select jurisdictions.

2. Tax policy objectives (neutrality and certainty)

Under a securitization arrangement, there are several areas where tax consequences can typically vary when compared to a scenario where the underlying assets have not been securitized. The tax policy for securitization would typically need to consider the following key aspects. These include:

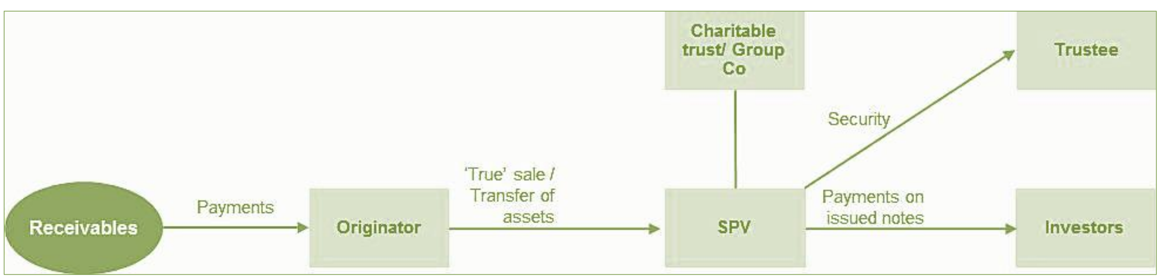
- The sale of the assets to the securitization vehicle (whether it is a true sale or otherwise)
- Income from the assets (e.g. interest)
- Bad debts

- The tax treatment of the securitization vehicle and the issuance of notes to investors
- Payments to investors (e.g. coupons)
- Transaction taxes (e.g. stamp duty, VAT / GST)

Specific tax rules that deal with securitization transactions can achieve tax neutrality by alleviating unintended tax consequences and inefficiencies such as tax leakage e.g. providing clarity regarding the timing of taxation, nature of income from underlying instruments, according pass through status wherever necessary etc. This approach should help eliminate unexpected tax consequences which can result in mispricing securitization transactions, requirements for complex tax indemnities and/or warranties and difficulties for ratings agencies to accurately rate the securitized assets and securitization vehicle.

In the absence of specific rules that explicitly address the above issues, there exist uncertainties for taxpayers which are impediments to the growth of the securitization market. An alternative to specific rules is the issuance of guidance on the taxation of securitization transactions. This alternative approach will allow participants in the securitization market to appropriately plan for the tax consequences of the securitization transaction which will allow efficient pricing and rating of the transaction.

Ultimately, these rules should result in the same tax outcome which would otherwise arise in respect of the securitised assets (i.e. they should be tax neutral). We consider this objective in light of the origination, life and termination of a securitization transaction.



3. The origination of the securitization transaction

On origination, the securitized assets are transferred to a special purpose vehicle. The transfer of the securitized assets may give rise to a taxable profit or loss. In Malaysia, asset backed securitization regulations provide originators of securitization transaction a specific set of rules that deal with the taxation of gains and losses from the disposal of trade receivables and stock in trade. Broadly, the taxation of such gains or losses is spread across the period of the securitization transaction. This treatment prevents upfront tax costs that may otherwise arise on the origination of the securitization transaction and is an example of tax neutrality on origination of the securitization transaction.

In addition to the above, the indirect and transaction tax consequences (including GST, VAT, stamp duty) of the origination of securitization transactions need to be considered and addressed. For instance, transfers of mortgage backed securities can have a complex interaction with existing stamp duty laws. It is foreseeable that the transfer of mortgages over land could give rise to stamp duty costs which, in a securitization transaction, can be difficult and complex (if not impossible) to calculate due to the large number of mortgages in a single transaction. Such laws should be updated to take into consideration the nature of securitization transactions such that the complexity and uncertainty is eliminated. This can be achieved through exemptions and/or clarifications on the application of such laws.

4. The life of the securitization transaction

The taxation of income and expenses during the life of a securitization transaction can depend on the tax residency of the special purpose vehicle, type of vehicle chosen and the relevant taxation regime. It is to be noted that special purpose vehicles in securitization transactions are intended to be profit neutral (income matches expenses). Accordingly, tax laws should provide symmetrical treatment between the income and expenses of the special purpose vehicle. That is, either both are taxable / deductible or both are exempt. In Malaysia, regulations exist for the taxation of income and expenses for the special purpose vehicles. Namely, gross income includes income from all sources and any deductible expenses incurred by the special purpose vehicle for acquiring trade receivables or stock in trade are spread across the period of the securitization transaction. These regulations match the timing of the income or gains of the originator with the expenses of the special purpose vehicle.

In Thailand, a special purpose vehicle is granted an exemption from tax on income derived from a securitization transaction which has the necessary approvals. Additionally, the operation and allocation of cash inflow for the settlement of debts and expenses must follow the approved plan. Similarly in Singapore, income derived by an approved securitization company resident in Singapore from asset securitization transaction is currently exempt from tax.

The added complexity of cross border securitization transactions also needs to be considered. During the life of a securitization transaction, it is possible that the originator, securitization vehicle, investor and debtor under a securitization transaction are tax residents in different jurisdictions. In such scenarios, withholding taxes, permanent establishment issues and tax treaty claims are relevant and can be complex. Whilst appropriate tax planning may reduce tax leakage in these circumstances, rules that support tax neutrality and tax certainty can provide participants' increased confidence to enter into securitization transactions. For example, where a collective investment vehicle is used as the securitization vehicle, withholding tax exemptions on relevant interest payments and distributions will minimize complexities arising from the interpretation of tax treaties. In this regard, Singapore currently has a withholding tax exemption for payments on over the counter financial derivatives in connection with an asset securitization transaction (subject to meeting the conditions of being an approved securitization company). Exemptions such as these remove the economic disincentive of additional tax costs in a securitization market.

A specific tax regime was introduced in the UK in 2007 in order to simplify the taxation of securitization companies. Under the specified UK tax regime, a company that meets the definition of a securitization company is in summary taxed on the small amount of "retained profit" rather than on the profit shown in its accounts. - in other words, the standard rules on taxable income and deductible expenses starting from the financial statements of the company do not apply (securitisation vehicles were previously taxed in this manner, and this led to complexities such as the SPV could have tax liabilities (based on its accounts) that exceed its cash surplus available to settle such liability).

The “retained profit” can be an amount or margin chosen by the directors of that company, provided that it is clearly identified in the securitisation documents, such as in the “priority of payments schedule”. Eligible securitization companies that meet the conditions are charged corporation tax on their retained profit, which is the amount left after the operation of the payments waterfall (with adjustments for certain dividends received and paid by the SPV). Where an SPV does not have available funds equal to its retained profit, corporation tax will be calculated on the amount of profit actually retained.

5. The termination of the securitization transaction

On termination of the securitization transaction, the securitized assets are transferred back to the originator (to the extent they still exist). In addition, any profits in the special purpose vehicle are required to be dealt with. The taxation of these events on termination should be considered and addressed within the context of tax neutrality and tax certainty.

6. Current taxation of securitization transactions – China

In 2006, Caishui [2006] 5 was released which provides China’s position on Business Tax (BT), Stamp Duty (SD), Value-Added Tax (VAT) and income tax on credit asset securitization.

As per this circular, there are no BT, VAT and SD implications when the relevant assets are being transferred to the securitization trust. The originators of securitization transactions are subject to enterprise income tax laws on the gains and losses made on the transfer of the assets to the securitization trust.

The securitization trust is exempt from enterprise income tax on gains that it distributes to the investors investing in securities backed by credit assets (ABS) issued by it, in the same year the amounts are derived. The securitization trust may however, be subject to enterprise income tax on undistributed amounts. However, the securitization trust is also subject to BT on interest received from credit assets.

On the other hand, institutional investors are subject to income tax on distribution received from the ABS. Institutional investors are also subject to income tax and BT on gains realized from the disposal of ABS.

In the context of credit asset securitization, the circular has achieved the objective of tax neutrality as the interest income should not be subject to double taxation. However, the circular is silent on several issues which may give rise to tax uncertainties to the obligors, originator, trust company and institutional investors of ABS e.g. BT exposure for originating bank arising from true-sale, issuance of statement of interest income / tax invoice to obligors, tax treatment of non-resident institutional investors, etc.

VIII. Regulatory framework (Clifford Chance)

Due to the severe consequences of over concentrations of risk and the dangers of interconnectedness there is a case for regulation of securitization activity. The form that regulation takes does, however, need to strike a delicate balance. It should not be product specific, preferring one particular financial product to another, but rather be focused on the activities – does a particular use of securitization result in a possible negative effect. This chapter outlines a number of regulatory tools which could be used by regulators to help foster an established and well maintained economically beneficial securitization market. The next chapter then explores which, if any, of these tools should be employed in China and more broadly in Asia to ensure securitization markets continue to develop in a stable and robust manner.

The regulatory tools which this chapter will focus on are:

- entity focused rules – whereby certain users of securitization are regulated; and
- activity focused rules – whereby certain features which might be present in securitization are regulated.

1. Entity focused regulation

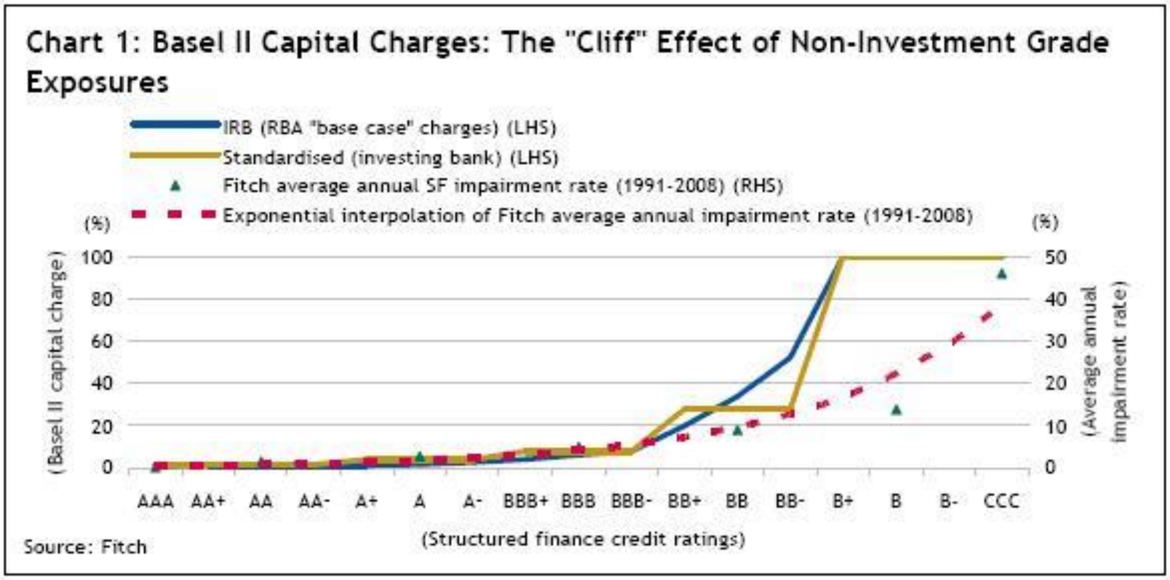
As banks and other financial markets participants are likely to be significant users of securitization technology it is important to consider what toolbox of regulatory options they could be constrained by. Understanding these options will then assist the analysis in the next chapter in ascertaining which of them might be appropriately employed in the Chinese and other Asian securitization markets.

In Europe and the US entity-focused regulation generally fall into the following categories.

Capital requirements

Capital requirements are designed to ensure that entities undertaking bank-like activity, such as leverage or maturity transformation, hold a sufficient amount of capital in order to mitigate the negative effect of losses. In general, the riskier a financial assets, the greater the capital which needs to be held against it. Capital requirements seek to make riskier positions more expensive for entities to hold and less risky positions cheaper for entities to hold.

This, however, leads to the complex question of how the "riskiness" of a securitization position is determined. A number of models have been adopted throughout Europe and the US which has led to an uneven playing field in some instances. A "cliff" effect, which results from the way certain capital requirement models operate, has also been subject to criticism.



(Source: Fitch Ratings: Basel II & Securitization (October 2009))

The above graph illustrates how a slight shift in credit quality, for instance, from BB- to B+ results in the capital charge increasing from 30 to 100. It is worth nothing however that the chart above is a historical one, but it nonetheless demonstrates how regulation can result in significant adverse capital impacts.

The regulatory framework has now evolved and there are currently new models being proposed by Basel III which are seeking to reduce the cliff effects in their calculations.

Large exposures

Large exposure rules seek to reduce the overall reliance of an entity on repayments from a single source or group of interconnected sources. The rules are often expressed by reference to an entity being able to have an exposure to a single debtor (or group of connected debtors) no greater than a certain percentage of its capital.

The idea behind the enforcement of a large exposure rule is to minimize the risk of one insolvent entity having a domino effect and resulting in the insolvency of a chain of entities. It is a rather blunt tool for ensuring there is a minimum level of diversity in the loans or investments made by an entity to which the rules apply.

Large exposure rules should, however, take into account specific features or certain markets or business models of particular financial markets participants. For instance, a specialized lender in a naturally concentrated market might struggle to operate within the boundaries of low-set large exposure thresholds but could provide a valuable alternative for borrowers to other, more general, providers of finance. In such an instance, such specialist lenders could help increase financial stability rather than hinder it.

Liquidity ratios

Basel III introduced the liquidity coverage ratio and net stable funding ratio. Rather than looking at an entity's overall assets compared to its liabilities, these ratios are designed to ensure that, on a day-to-day basis, an entity has a ready supply of cash or other liquid assets sufficient to cover its expected outflows. Liquidity ratios help reduce the overall level of maturity transformation within the financial system.

"Maturity transformation" – this is the process by which a bank or other market participant incurs a short term liability (for instance by taking a deposit from a customer which is repayable on demand) and then generating a long term asset (for instance granting a loan for the amount of the deposit which is repayable in a number of years). On the one hand the bank's assets match its liabilities in value terms, but if the customer comes to withdraw the deposit, the bank would have no cash available as it is not due the money back from its borrower for a number of years.

For instance, the liquidity coverage ratio requires banks to hold liquidity assets against expected outflows over the following 30 day period.

Key to the operation of a liquidity ratio is the assets which a financial institution can identify as being "liquid". In principle, cash or a security which can readily be sold to generate cash is a sensible test, however, in practice, whether or not a security can readily be sold to generate cash is a difficult question. To what extent must there be an active secondary market for that security? What is the historic performance of that, or similar, securities? Does that security have a credit rating? Are there any types of securities which should be excluded even if they have a rating? These questions lead to difficult decisions for regulators, who risk creating bubbles in certain securities by allowing them to be included in such ratios to the exclusion of other securities.

Leverage ratio

A leverage ratios essentially limit the overall level of an entity's exposures compared to its capital to be under a particular percentage. This helps limit the build up of leverage.

However, as riskier exposures carry higher returns, in isolation, a leverage ratio encourage entities to invest in riskier assets in order to generate higher returns on the limited level of exposures they can hold. For this reason regulators are often keen to stress that a leverage ratio should only ever be one of a number of measures used to reduce risk.

2. Securitization focused regulation

Regulation focusing on the activities which are securitization-like in nature can be target, ensuring the uses of securitization which led to increases in systemic risk and risk concentration within the financial system in the lead up to the global finance crisis are less likely to occur.

There are a number of ways securitization-like activities can be regulated – most such ways present in the US and Europe look at the features of securitization transactions which are understood to have increased systemic risk and limit the use of those features.

The regulation of rating agencies is a big topic which is beyond the scope of this discussion.

Investor diligence

In part as a consequence of over-reliance on ratings, regulators believed that some investors were not conducting their own diligence on securitization transactions. Complimentary to rules imposed on rating agencies, European regulators imposed requirements on certain investors in securitization transactions to undertake certain minimum levels of diligence themselves.

Such regulations generally require investors to maintain records to show they have considered a range of risk related issues. For instance:

- the risk characteristics of the security being issued under the securitization;
- the risk characteristics of the exposures underlying the securitization (e.g., the residential mortgages, trade receivables, auto-loans or other assets);
- the reputation and loss experience of earlier securitizations of the particular originator, arranger and asset class;
- the methodologies and concepts on which the underlying exposures have been valued; and
- structural features of the securitization, such as the waterfall, trigger events, credit enhancement, liquidity enhancement and the point when an underlying asset is considered to be defaulted.

In practice many of the investors to which these rules apply do not consider them particularly onerous as they already have procedures in place to ensure their credit assessment process is robust and, in many cases, already goes beyond the minimum required by the regulations.

Risk retention

Risk retention rules have been in place in Europe for a number of years and are currently being implemented in the US. The essence of such rules is to align the interests of a person who is doing the securitization (e.g., an originator or arranger) with the investors in order to provide comfort to the investors that the originator or arranger has a vested interest in ensuring the securitization and the underlying assets perform as expected. A particular business model which operated prior to the financial crisis was an "originate-to-distribute" model where an originator advanced loans to borrowers with the intention of fully securitizing those loans whereby investors would take all the risk in those loans following the securitization, leaving the originator with no risk. In such an instance there was no incentive on the originator to ensure the credit policies in place were robust enough to provide loans of a quality the investors were expecting.

The way alignment of interests between and originator or arranger and an investor is achieved is through ensuring the originator or arranger continues to be exposed to the credit risk of the underlying asset – although the details of European and US rules are different at a technical level, the rules generally provide that the originator or arranger should retain a 5% interest in the securitization – i.e., if there are defaults in the pool, the originator or arranger must share at least 5% of the loss.

Reducing complexity

An initiative currently being taken forward by European authorities involves looking at the complexity of a securitization transaction and, if the securitization is sufficiently simple, transparent and standardized, allowing those with exposures or interests in the securitization to be subject to capital rules and regulation more favorable than they would be were the securitization classified as more complex.

In July 2015 a list of features which European regulators might consider as being present in a simply, transparent and standardized securitization were published. They included:

- the securitization does not have any underlying exposures which are themselves securitization positions;
- the eligibility criteria for the securitization's underlying assets should be predetermined and clearly defined and there is no element of active portfolio management on a discretionary basis;
- the securitization involve a "true sale[34]" of the underlying assets and should not include severe "claw-back[35]" risks;
- the underlying assets should be homogenous in terms of their asset type and currency;
- the underlying assets should be performing;
- the securitization should include insolvency related triggers with regard to the originator and servicer;
- the securitization should include triggers related to the level of defaults experienced by the underlying assets;
- the servicer or administrator of a securitization should be able to demonstrate expertise in servicing or administering the particular type of underlying asset;
- including a minimum level of disclosure and information in the prospectus applicable to the securitization; and
- where legally possible, ensuring investors have access to all underlying transaction documents.

The scope and consequences of a securitization constituting a simply, transparent and standardized securitization do need to be carefully considered. For instance, if a securitization does not meet the criteria it does not necessarily mean it is a bad securitization – the regulators

[34] true sale – an expression used in the context of a transfer of assets (whether residential mortgages, corporate loans, trade receivables or otherwise) by an originator to an SPV which means that the transfer will be construed as a sale and recognised as such by all third parties, including an insolvency official of the originator. If an originator has properly transferred and sold the assets then they will not form part of its insolvency estate upon the originator's bankruptcy.

[35] claw-back – an expression which generally means upon the insolvency of an originator that originator's insolvency official, or any of its creditors, can argue that assets it has sold were not actually sold and should, instead, be brought back into that originator's insolvent estate. For instance, in many jurisdictions if the assets were sold at an undervalue or were sold with the intention of preferring a particular creditor of the originator, they can be "clawed-back" and will form part of the originator's insolvency estate and be available for distribution to the originator's creditors.

should not (and, in opinions and reports published in this context, are clear that they are not seeking) to prohibit or stigmatize securitization which do not meet these criteria, but rather allow simple, transparent and standardized securitizations to benefit from more favorable regulatory treatment.

3. Definitional issues

Trying to crystallize in words the nature of a securitization has proved difficult for both regulators and market participants who believe certain transaction should or should not fall within that definition. The Basel II[36] definition is, for instance, both over and under inclusive in the types of transaction which it applies to. For examples, layered corporate debt of an operating company in a leveraged financing can constitute a "securitization" where a single class of debt serviced by a ring-fenced portfolio of assets may not.

Another problem with the potential breadth of the definition of securitization lies in the regulatory effort to reduce or prohibit the "bad" securitizations which are widely perceived as contributing to the financial crisis while recognizing "good" securitizations and encouraging those as an essential and healthy part of a growing economy. Appreciating the consequences of labelling a particular transaction as a securitization is important and should very much relate to the nature of the individual type of product or transaction in question – a definition which covers a broad spectrum of financial techniques under a single heading will be, and has proved, in practice difficult to operate.

This is because there is no unifying concept of what a securitization is – as outlined in Chapter 2, securitization is far less of a particular product and more a tool box of techniques which can be put together as part of a transaction. A "one-size-fits-all" approach to regulation of securitizations will always be elusive.

Some suggestions of approaches to the regulation of securitization in China and Asia are explored further in Chapter 6.

4. Overlap and over-regulation

A final point to consider in the context of ways securitization can be regulated is the overlap with other areas of regulation. A wide range of participants engage in securitization transaction – among them are a number of entities which are already subject to regulation such as banks, insurance companies and funds. There is also increasing debate on the regulation of "shadow banking", which securitization is often considered part of.

As the regulation of each of these areas overlaps it is often unclear which regulations take precedence, whether they are mutually exclusive or whether they can coexist. Before any new regulation is introduced the questions should certainly be asked as to whether existing regulation in place, already binding on the participants involved, is already sufficient.

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[36] Basel II defines a traditional "securitization" as "*…a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures. The stratified/tranched structures that characterise securitizations differ from ordinary senior/subordinated debt instruments in that junior securitization tranches can absorb losses without interrupting contractual payments to more senior tranches, whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of liquidation.*"

There is no doubt that certain types of securitization can be positive force to help encourage growth in economies and over-regulating securitization or securitization participants may hinder its beneficial economic effect.

IX. The way forward for Chinese securitization and Conclusions (ASIFMA/ Clifford Chance)

This work has looked at securitization from a number of perspectives – taking in the history and development of securitization in the US and Europe, the features that make a particular transaction a securitization, why there is a case for an active securitization market in China, how securitization is operating and being developed both legally and practically in China and the various regulatory options available in order to regulate it.

What this chapter will do is explore how securitization should be regulated in China in order to derive the beneficial effects it can bring to its economy.

1. Unique Chinese economy

There are a number of unique features of the Chinese economy which differ significantly from the economies in the US and Europe. It would be wrong to think US and European regulation should (or even could) simply be imported into China and achieve the desired effect. First, there is already debate over whether that regulation works as efficiently as it could in the US and Europe and second, the differences in the Chinese economy means something tailored would result in a much better fit.

Some of these features of the Chinese economy include:

- there is an over-reliance on bank funding;
- capital markets are relatively undeveloped;
- banks are heavily leveraged;
- banks rely significantly on customer deposits for funding;
- complex credit intermediation structures and sophisticated financial engineering techniques are relatively rare;
- a high proportion of borrowing is used for investment rather than consumption;
- borrowing is largely driven by corporates rather than individuals and government; and
- there is little data on the historical performance of securitization transactions backed by Chinese assets.

2. How can securitization help China

Chapter 2 outlined a number of ways in which securitization can bring benefits to an economy. In China there are a handful of these benefits which are particularly relevant.

Deleveraging of banks

In an economy such as China where banks are highly leveraged (arguably creating systemic risks in the domestic Chinese banking market) and there is a desire on the part of government, regulators and banks themselves to reduce that leverage, securitization can be a very useful tool to help achieve that.

In shifting risk away from the banking system securitization techniques can be used to attain accounting and regulatory capital relief for institutions which originated portfolios of loans thereby freeing up their capital and reducing their leverage.

The securitization of loans in this way also connects non-bank investors with underlying borrowers meaning that credit is being delivered outside of the regular banking system. Delivery of a proportion of credit in this manner can be beneficial – it is generally far less leveraged than credit delivered to the economy by banks and is generally non-maturity transformed (i.e., the maturity of investors' assets generally matches the borrower's liabilities). This builds on the resilience of the financial system.

In an economy such as China, where there is a lot of borrowing for investment, long term assets, such as infrastructure and home loans do not fit as naturally with banks, which rely on short term funding sources, but can fit well with other types of investors, such as insurance companies or pension funds, who would be seeking exposure to those longer term assets.

Deeper capital markets

China's bond capital markets are generally seen as not having the depth and liquidity of equivalent markets in the US and Europe. Securitization can help in three respects on this front.

First, securitization creates an alternative investment product for investors. By repackaging assets which would otherwise be illiquid (such as auto-loans or infrastructure debt) a securitization opens up these types of investments to a range of participants in the capital markets who would otherwise not have been able to have that exposure. In the face of equity market turmoil, fixed income securities, such as securitization bonds and notes may well provide a popular choice.

Second, securitization provides a very different type of risk to a corporate or government bond – it gives exposure to a pool of assets, rather than the credit of an operating business. This different type of investment product can help investors diversify their risk.

Third, securitizations, within a regulatory framework, can be very transparent and provide a significant amount of data and information about the underlying exposures. This means investors can make very informed investment decisions and lends credibility to securitization as an investment product.

Diversification

Any time banks seek to deleverage there is a concern among borrowers that there will not be sufficient credit to meet their borrowing needs. This has been seen especially sharply in the US and Europe since the financial crisis where a number of banks have simply removed product lines from their businesses and stopped lending in certain jurisdictions they saw as too high risk. Small and medium sized businesses in the "real economy" have been particularly affected by this reduction in credit.

To countenance against a risk of a reducing level of credit being provided by banks, if a non-financial institution or a corporate is able to access the capital markets it provides them with an alternative source of funding. Securitization techniques allow corporates to have that access to capital markets which they would not otherwise have and consequently keeps credit flowing to the real economy.

Equally, banks in China (which have a heavy reliance on customer deposits for funding) can diversify their funding sources and take a proportion of their overall funding requirement from the capital markets through securitization. By having alternative sources of funding, particularly when compared to short-term liabilities such as customer deposits, banks can become more resilient to financial shocks.

A case for more securitization in China

There is clearly a case for the use of securitization in China. The existing legal and regulatory regimes also recognize this. But as the securitization market continues to grow thought needs to be given to what adaptations might be made to those legal and regulatory regimes to better equip them for the future.

3. Types of securitization

Chapter 3 highlighted the different types of asset classes typically securitized in China and also identified the types of entities which were doing securitization transactions.

What is clear is that the types of securitization transactions being undertaken generally fell into two categories:

- transactions, predominantly undertaken under the SPT structure, which essentially provide investors with ownership rights in an assets portfolio – what we might term *asset ownership in securities form*; and
- transactions, predominantly undertaken under the SAMP structure, which essentially provide a funding line from investors to a non-financial institution secured over certain assets of that non-financial institution – what we might term *lending to corporates on assets in securities form*.

Other securitization structures, which are more common in the US and Europe are not common at all in China. For instance:

- Chinese banks have not implemented secured treasury funding platforms (often structured as "master trusts" or covered bonds) where asset portfolios are used as collateral to raise on-going finance for a bank's treasury function. A particular feature of these platforms requires the originator to continually replenish the assets in the structure and make new issuances;
- more diverse investment products, which involve the repackaging and re-tranching of a portfolio of underlying bonds, are also uncommon; and
- synthetic risk acquisition products, using derivatives to transfer risks relating to portfolios of assets from an originator to investors, are often used by US and European banks to achieve regulatory capital relief but are little seen in China.

It is interesting that the securitization structures which are thriving in China are those which most accurately match the benefits securitization technology can bring to the Chinese economy:

- allowing investors to own asset portfolios in securities form (a) assists banks in deleveraging by sharing the risk they hold with investors and (b) contributes to a broadening and deepening of the capital by providing additional investment products for investors to invest in;
- secured lending in securities form secured on asset portfolios provides additional diversity to non-financial institutions which would otherwise be reliant, possibly over-reliant, on bank funding.

The absence in China of other securitization structures which are seen in the US and Europe is less a function of China needing to "catch-up" and more a function of how the Chinese economy has developed to date and what its individual requirements and characteristics are.

4. Regulation of securitization for the Chinese economy

Given the types of securitization structure which exist in China and the likelihood of their development over others, the question of how those structures should best be regulated can be considered.

Risk Retention

Where a securitization structure allows for the risk in an asset portfolio to be transferred to investors, it is sensible to ensure there is an alignment of interests between the person undertaking the securitization and the investors. This was discussed in detail in Chapter 8.

In China, this means that structures which pass ownership interests in asset portfolios to investors should require an alignment of interest and a requirement on an originator to retain a portion of the risk is justified.

In structures which are similar to lending secured over an asset portfolio there is already an alignment of interest as the entity receiving the funding would be intent on ensuring its business continued to operate as a going concern. There is no need, in such a case, for an additional requirement for some kind of retention requirement.

As outlined in Chapter 5, the Chinese regulatory authorities already adopt this approach – the SPT structure, which provides for asset portfolio ownership in securities form, has a 5% risk retention requirement while the SAMP structure, which is more equivalent to lending secured on an asset portfolio, does not specifically require risk retention – so no further regulatory requirements are needed in that respect.

Maintaining simplicity and ensuring transparency

The SPT and SAMP structures in China are relatively simple and straightforward compared to many US and European securitization structures. This makes them easier to understand and therefore more straightforward for investors to make investment decisions in respect of. As the securitization market develops, for public transactions, simpler structures should benefit from favorable regulatory treatment, whether that is achieved through lower risk weights for securitization positions in those structures, being allowed to use those securitization positions for central bank funding purposes or have them count towards liquidity or other funding ratios.

Scope of application

It is also worth considering the appropriate regulatory perimeter for which the regulation should apply. The Chinese regulators have a good basis in the form of the existing STP and SAMP structures for the types of securitization most prevalent in China at the moment. As new types of securitization develop, however, they should be considered in their own right – the existing structures might not be appropriate for them. Flexibility needs to be maintained and an open dialogue between the industry and the regulator will help to produce thoughtful, appropriate and workable regulation.

5. Looking forward

US and European regulation has recently been driven by certain systemic risks to which securitization markets those jurisdictions were exposed. China has less exposure to those risks but has its markets have their own risks. China must develop its own regulatory regime which best fits its own securitization market. This has been happening to date, with a steady growth of securitization balanced by regulatory regimes which seek to promote the positive aspects of securitization.

Securitization can be an important contributor in helping China continue to develop and grow a stable, robust and resilient economy.

X. The Outlook for cross-border issuance and conclusions (ASFIMA)

As we have seen in the course of our extensive discussions above, it is worth noting that regulatory and market frameworks governing securitization, especially in China, are relatively nascent. Moreover, generally speaking, we have demonstrated that Asian domestic securitization markets are more active relative to their cross-border counterparts. Indeed, Asian cross-border issuance, which was (and still remains) a fraction of US and European issuance, dropped sharply post 2008 as the market for CDOs (which accounted for the bulk of Asian issuance pre-2008) virtually shut down. In terms of securitizations aimed entirely at domestic market investors, Korea was dominant but the fast-growing Chinese market has taken the lead.

After hitting a peak of USD 8.0 billion in issuance (meeting international scale ratings – basically cross-border securitizations) in 2007 (*source: Standard & Poor's, BIS*), this fell to USD 5.8 billion in 2008 and even more sharply to USD 2.3 billion and USD 1.7 billion in 2009 and 2010 respectively (*source: Standard & Poor's, BIS*). The primary reason for the fall in internationally rated cross-border issuance was the slump in regional CDO issuance, which was a sizeable USD 3.0 billion in 2006, USD 5.0 billion in 2007 and approximately USD 4.0 billion in 2008, but then slumped to almost nothing in each of the two subsequent years (*source: Standard & Poor's, BIS*). In the years prior to 2008, CDOs offered a way for the region's issuers with lower ratings to meet the region's investor needs for highly-rated paper. A diversified portfolio of lower-rated credits can obtain a higher rating through a properly structured CDO, but in the aftermath of the events of 2008, the market for these structures fell sharply, along with Asian investors' appetite for risk.

CLOs retain their appeal

However, unlike CDOs which suffered a severe dent to their reputation, CLOs did not suffer as badly during the crisis years and CLO issuance globally rebounded sharply after the slump of 2009-2011. CLOs are typically backed only by corporate loans (unlike CDOs, which in their heyday had underlying mortgage assets lumped in as well, a factor that contributed to their poor performance during the crisis). Indeed, in a low interest rate environment, the mezzanine tranches of CLOs with investment grade ratings are particularly attractive for certain classes of Asian investors, such as Korean (and Japanese) insurance companies who have guaranteed high payouts on insurance policies and other products sold to investors in the past. Generally speaking, this popularity of CLOs is set to continue, more so as the Asian investor base develops a degree of sophistication that allows them to consider alternative asset classes. Indeed, the big prize remains the domestic CLO market in China as international access to this asset class, which is growing by leaps and bounds, will help change the face of securitization in the region.

Looking ahead, it remains to be seen how recent regulatory changes - primarily The Volcker Rule and the risk retention requirement for securitizations introduced in both the USA and Europe - impact cross-border CLO issuance. On account of the inability of bank proprietary desks to hold certain tranches of legacy CLOs as a consequence of the Volcker Rule (which restricts proprietary activity), spreads on the highest-rated tranches have widened (which will necessarily mean the spreads on lower-rated tranches have to narrow, everything else being equal). This could have a marginally negative impact on investor appetite for the mezzanine tranches. Finally, the 5% risk retention requirement imposed on CLO managers until maturity, both by the EU's CRD (Capital Requirements Directive) and the Dodd-Frank Act in the US could also impact CLO originations, although that has not been in evidence thus far.

Other Asset Classes and Covered Bonds

Turning to the other securitized cross-border asset classes within the region, Korea has one of the most developed securitization frameworks. The passage of the ABS Act, post-Asian crisis in September 1998 with the establishment of a "True Sale" framework, and the legislation enabling the issue of covered bonds much later, has led to considerable development of the Korean cross-border ABS market. Apart from Korean credit card and auto loan ABS, the "future flow" securitization carried out by Korean Air in 2011 is noteworthy (although the structure itself is not new and has been implemented both within the region and elsewhere much earlier).

Singapore has also passed covered bond legislation and further regional covered bond issuance would be a positive development.

The Regulatory Framework and Conclusions

As the foregoing discussions have shown, in recent years, there have been considerable enhancements/improvements to the Chinese securitization framework since the establishment of the CBRC/PBOC and the separate CSRC pilot programs in 2005. For example, CBRC, CSRC and the PBOC recently relaxed the existing rules to allow a new notice filing system from the more restrictive application/approval process on a case by case basis that was used in the past. Furthermore, the CSRC also clarified that ABS issuers could use SPV structures (something not explicitly provided for under Chinese law) and expanded the range of assets eligible for ABS. Even so, there is more that needs to be done, in our view.

At the most basic level, the CBRC and PBOC instituted the Credit Asset Securitization framework on the one hand and the similar guidelines introduced by the CSRC on the other, are in the nature of administrative guidelines and do not have the force of a statutory law (something which only the National People's Congress can enact). Additionally, the roles of a trustee and loan service company are clearly well defined in the more established jurisdictions but are still evolving in China. Finally, issues related to ratings, tax, swaps documentation, close-out netting and access to underlying assets in the event of bankruptcy all require a greater degree of clarity/resolution before international investors get a higher level of comfort with China securitizations.

In conclusion though, as China plays an ever greater role in the global economy, its currency will internationalize at a much faster pace and, moreover, by some measures (such as holdings by central banks), the renminbi is already a de facto reserve currency. As more investors seek to hold assets in the Chinese currency, securitization offers them an attractive option for diversification. More importantly, from the issuers' point of view, securitization offers an excellent option to de-risk balance sheets and more efficiently use capital. Finally, regulators too have an incentive to encourage securitization to enable them to meet policy objectives. Clearly, securitization is one asset class whose future seems assured with China set to be the new frontier.

XI. Appendices

1. Appendices chapter VI. The Ratings Framework for Securitization - The "A to Z" of Credit Research on Structured Finance

The process of researching credit fundamentals, reaching rating conclusions and keeping market participants informed of Moody's ratings is the same for structured finance as for other segments of the credit markets. The entire rating process is designed to provide investors with timely rating information.

At the start, Moody's analysts and the issuer will have preliminary and non-deal specific discussions on the proposed transaction, such as the asset types and the high-level transaction structure. Our analysts will also explain the applicable rating approach and methodology.

The deal-specific rating process will start upon the issuer client's engagement for us to rate the transaction. The process will include the following steps:

- Provision of detailed transaction information, including description of the underlying assets, operational aspects and transaction structures.
- Operation review meeting with the sponsor and, where applicable, meetings with other relevant transaction parties, such as lawyers and appraisers.
- Evaluation of the credit risks of the transaction.
- A review of all transaction documents, including the relevant legal and tax opinions.
- Determination of the appropriate rating level through the rating committee process.
- Dissemination of assigned rating through the issuance of press releases and rating reports via various channels, including Moody's website and newswires.
- Continuous rating surveillance throughout the entire term of the transaction.
- Appropriate rating actions based on the change in the credit profile of the transaction.

Besides deal-specific surveillance, Moody's analysts also maintain continuous surveillance for changes in the legal and regulatory environment and changes in the credit quality of the issuer or third-party providers of credit support, to assess whether there is any reason to re-evaluate the rating.

2. Individual firm description

1.1 King & Wood Mallesons

King & Wood Mallesons are the first international legal network headquartered in the Asia-Pacific region, combining the leading law firms in China and Australia with a leading European-based international law firm.

Our market-leading securitization and structured finance team has broad experience working on structured products backed by a wide range of asset classes involving key jurisdictions in the Asia-pacific such as China, South Korea, Singapore and Australia.

Securitization and structured finance rankings

IFLR1000 (2014):

- Structured Finance and Securitization – Tier 1
- Bank Lending – Tier 2

Asia-Pacific Legal 500 (2014):

- Structured Finance and Securitization – Band 1
- Debt Capital Markets – Band 2

Chambers Asia Pacific (2014):

- Debt Capital Markets – Band 2
- Securitization – Band 2 with leading lawyer in Band 1
- Derivatives & Structured Products – Band 2

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Tiecheng is the head of the China financial regulatory team and a partner in the finance group in Clifford Chance's Beijing office.

He has over 20 years' experience advising on matters relating to China's financial services industry, including the Shanghai Hong Kong Stock Connect, the Shanghai Free Trade Zone, RMB internationalization, banking, derivatives, structured products (securitizations), funds (QFII, QDII and RMB funds), securities and insurance. He has a particular focus on China's financial regulatory environment, and has made significant contribution over the years to its development.

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Maggie is a partner in the Structured Debt Group of London Capital Markets. She is experienced in advising originators and arrangers on all forms of structured debt and financing transactions with particular focus on auto related securitization solutions (including private and public fleet securitization and auto loan/lease receivable securitization), residential and commercial real estate financing, structured SME financing, whole business, credit cards, conduits and restructuring. In addition to European structured debt work, Maggie also covers Asian and in particular Chinese securitization. She worked in the Beijing office of Clifford Chance between 1999 and 2001 and is one of the very few European securitization lawyers who are also conversant with the Chinese securitization regime and structure. Maggie also leads all initiatives and activities of the Clifford Chance London China Desk.

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James has over 22 years of international corporate tax experience and has been based in Hong Kong since 2001 focusing on international tax, transfer pricing and Hong Kong tax. He has also spent time working in Australia, the UK and Latin America.

His clients include a number of global financial institutions and Asia Pacific based financial institutions in the banking and capital markets, Insurance, Asset management and commodity trading sectors. James advises on the international and Asia Pacific tax aspects on various tax related activities, such as double tax treaties, international tax matters, and tax implications of regulatory and hybrid capital, cross border financial transactions and operational tax matters.

James also advises a number of commodity traders and corporate treasury centers in the region on Hong Kong and international tax issues arising from their operations, such as debt and equity raising, cash pooling and withholding tax matters.

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He has been responsible for managing various multi-jurisdictional tax projects for large foreign banking groups and capital market players. The projects centrally managed by him have covered various cross border tax aspects including inbound investments into Asian markets like India, China and Japan, sale of multi-jurisdictional loan portfolios by foreign banks, tax analysis of banking and capital market products.

He also managed the delivery of multi-jurisdictional operational tax projects (including health checks) for a number of foreign banks and capital market players across jurisdictions in Asia-Pacific.

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Claire is a senior director in Fitch Ratings' covered bond team in Sydney, Australia and is responsible for covered bonds ratings issued out of the Asia-Pacific region. She is also the author of Fitch's APAC Covered Bonds Quarterly publication that covers all Fitch rated Australian, New Zealand, Singapore and South Korean covered bond programs.

She moved to Sydney in mid-2013 after being based in Fitch's covered bond team in London, since January 2010. While there, Claire was involved in rating covered bonds issued out of Ireland, Netherlands, Canada, United Kingdom and Norway.

Claire joined Fitch in October 2006 in Sydney Australia and was previously responsible for structured finance ratings across RMBS, CMBS and ABS for Australia and New Zealand. She had worked in the securitization industry close to 10 years.

Claire holds a Bachelor of Information Management from the University of Canberra and Graduate Diploma in Applied Finance and Investment from the Securities Institute of Australia.

Recent Covered Bond Programs:

- DBS Bank Ltd Mortgage Covered Bonds (Singapore)
- Kookmin Bank Mortgage Covered Bonds (South Korea)
- Australia and New Zealand Banking Group Limited Mortgage Covered Bonds (Australia)

- Commonwealth Bank of Australia Mortgage Covered Bonds (Australia)
- National Australia Bank Limited Mortgage Covered Bonds (Australia)
- Suncorp-Metway Limited Mortgage Covered Bonds (Australia)
- Westpac Banking Corporation Mortgage Covered Bonds (Australia)
- ANZ Bank New Zealand Limited Mortgage Covered Bonds (New Zealand)
- ASB Bank Limited Mortgage Covered Bonds (New Zealand)
- Bank of New Zealand Mortgage Covered Bonds (New Zealand)
- Kiwibank Limited Mortgage Covered Bonds (New Zealand)
- Westpac New Zealand Limited Mortgage Covered Bonds (New Zealand)

King & Wood Mallesons

Roy Zhang

Partner

Roy Zhang is a partner based in Shenzhen / Hong Kong and specializes in debt capital markets, structured finance and private finance.
He concentrates his practice principally in the areas of both debt and equity financing transactions with an emphasis on leveraged financing, structured financing and technology focused industries. He represents commercial and investment banks, private equity, venture capital investors, industrial sponsors, and private and public companies, in all aspects of complex business transactions, including leveraged buy-outs and financings, strategic mergers, acquisitions and joint ventures, minority equity investments, and debt and equity restructuring. Roy has led transactions in a wide variety of industries including financial services, energy, biotechnology, healthcare, mining and mineral, logistics and transportation, and infrastructure.

Roy joined King & Wood Mallesons as a partner in 2006 and before that he had practiced as partner with another renowned Chinese law firm since 2001.

Recent Securitization Transactions

- GMAC-SAIC AFC 2012 - 1 Retail Auto Loan Securitization
- SAIC Finance 2012 - 1 Retail Auto Loan Securitization
- Huarong 2014 -1 Restructured Loans Securitization

- Dongfeng Nissan AFC 2014 - 1 Retail Auto Loan Securitization
- Citic Bank 2014 - 1 CLO Securitization
- Bank of Shunde 2014 - 4 CLO Securitization

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Paul McBride

Partner

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Paul has a broad range of structured finance experience representing all market participants including financiers, arrangers, monoline insurers, originators, swap counterparties, rating agencies and investors.

Representative matters

- PRC property financings using on-shore/off-shore secured lending and CMBS structures.
- Securitizations backed by many asset types across jurisdictions including residential and commercial mortgage loans, personal loans, credit card receivables, trade receivables and insurance receivables.
- Establishment of and issues under series segregated secured MTN programs, vanilla MTN programs and CP programs.
- Derivative master, credit support and trade documentation including ISDA, GMRA and GMSLA.
- Corporate derivatives and equity, rates, FX, bond, commodity and credit derivatives including Asia's first property derivative.
- Asset based trade finance using documentary credits, lending, repurchase and prepayment funding structures.

Reputation

"The firm's Paul McBride has a strong practice in the securitization market in Hong Kong."
IFLR1000, 2014

“Paul McBride has formidable experience in securitization.” Chambers Asia Pacific, 2013

“The ‘client-focused and solution-driven’ Paul McBride is highly regarded.” Asia Pacific Legal 500, 2013

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Partner

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Eddie has been practicing in China since 2004 and has extensive experience in advising major international commercial banks, investment banks, assets managers, hedge funds, private equity funds, developers and sponsors on China related projects, M&A transactions, structured finance, acquisition finance, real estate finance, financial institution acquisition, distressed debts and workout and other domestic or cross-border matters.

Eddie has advised a number of banks, auto finance companies, financial companies in their asset-backed securitization transactions.

Eddie joined King & Wood Mallesons in 2007 and before that he had practiced as in-house legal counsel in Mitsubishi Corporation.

Eddie also has qualifications of Certified Public Accountant, Certified Tax Agent and Certified Public Valuer in PRC.

Recent Securitization Transactions

- GMAC-SAIC AFC 2012 - 1 Retail Auto Loan Securitization
- SAIC Finance 2012 - 1 Retail Auto Loan Securitization
- Huarong 2014 -1 Restructured Loans Securitization
- Dongfeng Nissan AFC 2014 - 1 Retail Auto Loan Securitization
- Volkswagen AFC "Driver" 2014 - 1 Retail Auto Loan Securitization (representing Fitch Rating) Bank of Ningbo 2014 - 1 CLO Securitization
- Citic Bank 2014 - 1 CLO Securitization

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YuCheng Lin

Registered Foreign Lawyer

YuCheng Lin is part of the Hong Kong banking and finance team and primarily advises on securitization and corporate loan transactions across Asia, including Korea, China and Singapore.

YuCheng is also the key person involved in the “first-to-market” single loan repackaging deals backed by an onshore demand guarantee, and has been involved in nearly all repeats of such structures in the market since the first product was launched in 2013.

In addition to his banking and finance work, YuCheng has a broad range of corporate experience encompassing cross-border private M&A work, public takeovers, general corporate work and advisory work relating to regulatory and securities laws issues. He is proficient in reading, writing and speaking English and Chinese (Mandarin).

Representative matters

- “First-to-market” issuance of rated PRC-policy bank guaranteed single-loan repacks with a listing on a major stock exchange.
- Securitizations backed by many asset types across jurisdictions including residential and commercial mortgage loans, personal loans, credit card receivables, trade receivables and insurance receivables.
- Asset-backed loans with trade and lease receivables as security.
- Derivative master, credit support and trade documentation.
- Asset based trade finance using documentary credits, lending, repurchase and prepayment funding structures.

Commodity financing involving bespoked tripartite prepayment and repo arrangements.

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Moody's

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Jerome is responsible for covered bonds and structured finance transactions in Asia (ex-Japan). His portfolio includes CDOs CMBS, RMBS and various types of ABS.

He has analyzed a number of first-time covered bond and structured finance issuance in Asia, such as Korean and Singapore covered bonds, as well as China cross-border CMBS. He has also rated a number of China auto loan ABS.

Jerome received his Bachelor of Arts degree from the University of Hong Kong and Bachelor of Law degree from Manchester Metropolitan University.

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Georgina Lee

Assistant Vice President – Research Writer

Georgina Lee is currently an Assistant Vice President - Research Writer in the Asian Structured Finance Group based in the Hong Kong office.

She is responsible for generating research content and writing on the development of the structured finance market in Asia.

Prior to joining Moody's in 2014, Georgina had been a financial journalist for 15 years, covering a wide range of sectors. Her roles included writing for "Asia Risk" magazine where she focused on financial risk management, derivatives and structured credit.

Georgina received her Bachelor of Social Science degree in geography from the Chinese University of Hong Kong.

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