DEVELOPING SECURITIZATION LAWS IN CHINA

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I. Introduction

Although there is no question that the 2007-2008 downturn in the U.S. housing market was severe, the full extent of the severity remains uncertain. Moreover, as the United States economy falters, the rest of the world—from Europe to Asia—shares the burden. The other economic story, somewhat overshadowed recently by the U.S.’s troubles, has been the continuing boom of China’s economy. The timing of the U.S. housing market crisis is precarious, as the Chinese economy nears a crossroads: growing inflation, possible economic slowdown, ongoing corruption, and increasing demand for liberalization from international community.

After two and half decades of economic reform, China has blossomed into one of the world’s largest economies. But its growth relies heavily on its bank-dominated financial system, which has been called the economy’s “Achilles’ heel.” Large Chinese banks are state-owned and have always had a close relationship with state-

1 J.D., Boston University, 2008; B.A., Northwestern University, 2005. The author would like to thank her parents, Joan and Henry, for their love and support.


4 See, e.g., Keith Bradsher, China Reports Another Year of Strong (or Even Better) Growth, N.Y. TIMES, Jan. 26, 2006, at C5. In 2005, China was already the fourth largest economy in the world, behind the United States, Japan, and Germany in economic output. Id.

owned enterprises (“SOEs”). Despite nearly 30 years of gradual banking reforms—and undeniable improvements—Chinese banks are still plagued by an “inability to endure financial crises, poor bank management, risky loan practices, and scandals.” Chinese state-owned banks’ most notable problems arise from managing their large amount of outstanding non-performing loans (“NPLs”) and guaranteeing quality new loans. This Note addresses this problem facing China’s state-owned banks and examines asset-backed securitization as a possible solution, arguing that asset-backed securitization might provide an effective way to manage NPLs and to increase state owned banks’ efficiencies.

Part II of this Note discusses China’s state-owned banks’ non-performing loan problem and outlines the conflicting goals of reforming the banking system and the need to meet various social demands (and why they sometimes conflict). Subsection II.A provides a brief history of the Chinese banking industry and China’s general economic development. Subsections II.B and II.C summarize major reforms in the past two and half decades and the emergence of Chinese banking laws. Subsection II.D addresses why banking reform is imperative for China’s economic and social stability, and it concludes with current issues faced by the Chinese banking industry. Part III and subsection III.A examine asset-backed securitization as a possible solution for Chinese state-owned banks. Subsection III.B addresses the regulatory concerns unearthed by U.S. subprime mortgage crisis. Subsections III.C, III.D, and III.E compare and contrast the legal framework for securitization in China and the U.S. and analyze the risk of similar crisis in China. Section III.F explores possible alternative forms of securitization. Finally, Part IV concludes with recommendations for future regulation given the close relationship between China’s central government, SOEs, and state-owned banks.

6 Id.
8 See, Dobson & Kashyap, supra note 5.
II. Transformation of Chinese Banks

A. “Qian Zhuang” or the Government’s Cashier?

Traditionally, banks in China are called “qian zhuang,” which literally translates to “where the money resides” or “a place where money is deposited and lent and a profit is made.” While the word artfully captures what most of us think a bank’s general purpose is, large Chinese banks are state-owned and their purpose is to broadly serve the central government rather than simply to make profits. Until China took steps to reform its banking system in the late 1970s, Chinese banks “operated more like a government administrative agency to perform the government’s economic and monetary policies” as the central government’s “bookkeepers and cashiers.” In recent years, independent banks have emerged, but China’s largest banks remain state-owned. The relationship between state-owned banks’ and the central government (and consequently with the SOEs) are at the root of Chinese banks’ current non-performing loan problem. Policy lending—“lending based on policy objectives or political criteria and connections rather than creditworthiness”—continues to guide Chinese banks.

China’s first bank, People’s Bank of China (“PBC”), was created contemporaneously with the birth of the People’s Republic of China in 1949. PBC served as China’s only deposit taking and lending institution, as well as, the country’s central bank from 1949

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10 Dobson & Kashyap, supra note 5.
12 Qian, supra note 9, at 481.
14 See Dobson & Kashyap, supra note 5, at 6.
15 Id.
16 Id.
17 Qian, supra note 9, at 480.
until the late 1970s when China established four more banks. These four state-owned commercial banks (collectively, the “Big Four”), are the Agricultural Bank of China (the “ABC”), the Bank of China (the “BoC”), the Industrial and Commercial Bank of China (the “ICBC”), and the China Construction Bank (the “CCB”). The Big Four are specialized banks, catering to various industries and providing policy lending. The modern Chinese banking system still revolves around the Big Four, though smaller independent banks have emerged to satisfy the country’s growing banking needs: “In 2006, the Chinese banking system consisted of 19,797 institutions, including 3 policy banks, 4 large state-owned commercial banks, 12 joint stock commercial banks, 113 city commercial banks, 14 locally incorporated foreign bank subsidiaries and the rest made up of urban and rural credit cooperatives and other financial institutions.” This Note focuses on the Big Four that continue to dominate the country’s banking industry.

Prior to the first banking reforms in the early 1980s, China’s economy followed a centrally planned model where the Communist Party directed state-owned enterprises to operate key industries. These SOEs employed millions of people and produced one-third of the country’s industrial outputs. They also relied heavily on the central government and state-owned banks to survive: “SOEs essentially borrow[ed] money from people through state banks to maintain their inefficient business while thrifty Chinese people live[d] by working for SOEs.” Chinese households placed most of their salaries and savings at the banks, and state-owned banks held around 70 percent of the total domestic household savings. In turn, at the command of the Communist government, state banks lent this money to finance SOEs. From the beginning, the central government acted as guarantor for the SOE’s debts and wrote off

18 Id. at 481-82.
19 Dobson & Kashyap, supra note 5, at 6.
20 Id.
21 Id.
22 Matthews, Guo, & Zhang, supra note 13.
23 See Chen, supra note 11, at 242.
24 Id.
25 See id.
26 Id. at 241-42.
27 Id. at 241.
28 Id.
29 McCullough, supra note 7, at 425.
those debts when the SOEs defaulted.\textsuperscript{30} It is no surprise then that the state owned enterprises’ perverse incentives to rely on the government and citizens’ savings for bailouts created inefficiency and wastefulness.

This relationship between the SOEs and state-owned banks created a large amount of non-performing loans.\textsuperscript{31} After Deng Xiaoping started economic reform to modernize and privatize SOEs in January 1992,\textsuperscript{32} most of the state-owned banks’ loans to the SOEs became NPLs.\textsuperscript{33} In 2003, the Chinese government estimated the amount of such NPLs at around $240 billion,\textsuperscript{34} and independent estimates ranged from $410 to $815 billion.\textsuperscript{35} The problem of such a tremendous amount of NPLs is exacerbated by the fact that loans to SOEs made up around 75 percent of all bank loans as late as 1999.\textsuperscript{36} Thus, bank reforms that target NPLs must be an important focus for China.

B. Three Stages of Banking Reforms

China’s bank reforms can be divided into three stages: before 1993, from 1993-1997, and 1997 to the present.

1. Stage I of Reform: Before 1993

Banking reforms prior to 1993 were conducted as a part of the general SOE reform.\textsuperscript{37} State-owned banks “were still essentially governmental agencies supporting the SOEs,”\textsuperscript{38} and banks had little ability to recover bad loans to defaulting SOEs.\textsuperscript{39} Banks received lending instructions from the central government and did not have the authority to reject SOEs’ loan applications from state owned enterprises.\textsuperscript{40} Further, banks did not have judicial recourse to collect

\textsuperscript{30} Id.
\textsuperscript{31} Id.
\textsuperscript{32} See Qian, supra note 9, at 480.
\textsuperscript{33} See Chen, supra note 11, at 243.
\textsuperscript{34} Id. at 240-41.
\textsuperscript{35} Id.
\textsuperscript{36} Id. at 243.
\textsuperscript{37} Id. at 246
\textsuperscript{38} Id.
\textsuperscript{39} Id.
\textsuperscript{40} See McCullough, supra note 7, at 425.
on loan claims against the SOEs.\footnote{Chen, supra note 11, at 246.} Like Chinese banks, Chinese courts are merely extensions of the central government, rather than independent entities.\footnote{Id.} Courts only performed administrative and evidence gathering functions and, thus, could not assist banks in collecting defaulting loans.\footnote{Id.}

One notable development during this period was the inception of a centralized banking system. The Big Four, as well as the PBC, began to gain some independence from the government.\footnote{Id. at 244-45 (“[T]he State Council waited until 1986 to promulgate the ‘People’s Republic of China Provisional Regulations Related to Bank Management’ that gave People’s Bank the legal basis to operate as China’s de facto central bank.”).} In 1986, almost 40 years after the creation of the People’s Bank of China, the State Council gave the PBC the legal authority to supervise the country’s financial markets.\footnote{Qian, supra note 9, at 483.} Even though the PBC did not exercise its financial supervisory authority until years later, this reform signaled China’s desire to move toward a modern banking industry.

2. \textbf{Stage II of Reform: 1993 -1997: Empowering the PBC}

In 1993, PBC grew into China’s central bank when the government issued “the Decision of Financial System Reform,”\footnote{Id. at 244-45} declaring that the PBC has the sole responsibility of implementing monetary policy, controlling the Renminbi Yuan, and managing the country’s credit supply.\footnote{Id.} During this period China also passed several major banking laws which subsection II.D discusses below.

The newly empowered People’s Bank of China faced its first challenge during the domestic inflation crisis of 1993-1994.\footnote{Chen, supra note 11, at 245 n.26 (citing JINGLIAN WU, ECONOMIC REFORM IN CONTEMPORARY CHINA 212-13 (2004)).} China experienced rapidly increasing inflation as the central government attempted to stimulate economic growth through an interest rate decrease by encouraging spending and output.\footnote{Id. at 246-47.} In a mature banking system like the U.S., the Federal Reserve fights inflation by setting...
interest rates and through other monetary policies. Yet, at least then the People’s Bank was neither efficient nor autonomous enough to properly address the problem.\textsuperscript{50}

The inflation crisis of 1993 was something of a revelation for the Chinese government. Two years later, the central government delegated important powers to the PBC.\textsuperscript{51} The People’s Bank of China received the power to regulate the foreign exchange rate for the Renminbi Yuan and to control the foreign currency exchange process.\textsuperscript{52} The government also allowed competition from foreign banks.\textsuperscript{53} With these changes, state-owned banks entered the last stage of the reform which started with the 1997 Asia financial crisis.

3. Stage III of Reform: 1997 until present

China was not severely affected by the 1997 Asian financial crisis because Chinese banks were still an extension of the central government and thus somewhat insulated.\textsuperscript{54} However, the fact that Chinese banks held more non-performing loans than any of its neighbors jolted the central government into more substantial banking reforms.\textsuperscript{55} China’s entry in 2001 into the World Trade Organization provided additional pressure for reform.\textsuperscript{56} In its WTO Agreement, China promised to fully open its banking market to foreign competition by the end of 2006.\textsuperscript{57} Faced with the prospect of inevitable and fierce foreign competition, it became necessary to create an efficient commercial banking sector in China.\textsuperscript{58} Yet such a thing was easier said than done, because China had to both clean up the banks’ non-performing loans and at the same time balance the need for economic growth with the problem of uneven regional

\textsuperscript{50} See id. at 247.
\textsuperscript{52} Qian, supra note 9, at 483.
\textsuperscript{53} Id. at 483-84.
\textsuperscript{54} Chen, supra note 11, at 240.
\textsuperscript{55} Id.
\textsuperscript{57} Matthews, Guo, & Zhang, supra note 13, at 2.
\textsuperscript{58} See id. at 2.
growth. Even though earlier reforms reduced the ratio of non-performing loans held by the Big Four from 52.7% in 1997 to around 31.5% in 2000, in 2003, estimates of the amount of NPLs was anywhere between $230 billion and $815 billion in 2003. Indeed, one commentator estimated that “the cost of cleaning up the Big Four’s misdirected loans through 2005 can be conservatively put at roughly 10.4 percent of China’s 2005 GDP.”

The central government proposed several solutions to the non-performing loan problem. First, in 1998, the government vowed to bail out SOEs for the last time and committed 270 billion Yuan ($32.6 billion) to finance various state-owned enterprise debt with the state-owned banks. Second, the government formed several asset management companies (“AMCs”) to purchase $168.1 billion of NPLs from the state-owned banks and to sell them in secondary markets. This plan was designed to rebuild the capital base of state-owned banks and at the same time allow the AMCs to efficiently sell or use NPL assets. But the AMCs failed because they were unable to dispose of the assets quickly enough to cover their own costs. Their failure was attributed to their reluctance to auction off state assets at fair market value for fear of being criticized of selling them too cheaply. Likewise, employees at the AMCs did not have proper incentives because their employment depended on the existence of NPLs; if you did your job correctly you’d lose your job as reward.

But while many of these reform-minded policies have been successful for South Korea, they failed to achieve their desired effects in China. So in 2003, the PBC again was forced to subsidize the Big Four under the danger of a financial downturn caused by non-performing loans. And there is also ample evidence that the problem persists today. In November 2007, the China Banking Regulatory Commission (the “CBRC”) ordered a blanket lending

59 See generally Dobson & Kashyap, supra note 5.
60 Matthews, Guo, & Zhang, supra note 13, at 4.
61 Chen, supra note 11, at 240-41.
62 Dobson & Kashyap, supra note 5, at 8.
63 Chen, supra note 11, at 251; Dobson & Kashyap, supra note 5, at 7.
64 Dobson & Kashyap, supra note 5, at 7.
65 Chen, supra note 11, at 251-53.
66 Id.
67 Dobson & Kashyap, supra note 5, at 32.
68 Id. at 31.
69 Id.
70 Chen, supra note 11, at 251.
freeze. \footnote{James T. Areddy, \textit{China Freezes Lending to Curb Investing Frenzy}, \textit{Wall St. J.}, Nov. 19, 2007, at A1.} The CBRC ordered Chinese banks to freeze outstanding loan amounts to that of October 31, 2007 in an effort to curb runaway investments likely to become non-performing loans. \footnote{\textit{Id.} at A13.} Such a “blanket edict to halt lending growth is unusual,” even for the heavily regulated Chinese economy, and it epitomizes the country’s growing concern over the banking industry and its impact on the booming economy. \footnote{\textit{Id.} at A1.} Despite decades of reform, NPLs remain a threat to China’s fragile banking system and its general economic growth. \footnote{\textit{Id.} at A13.} Commentator Wendy Dobson has summarized:

> The gradual pace of reform in China, particularly of the government’s involvement in bank ownership and decision-making, postpones the day when [an efficient banking system] arrives. This choice of continued public sector involvement reflects a basic trade-off between, on the one hand, greater efficiency in state-owned institutions, of which the banks are an important part, and, on the other, stable employment growth and, more recently, rural-urban and regional equality . . . . The dependence of China’s government-affiliated firms on the state-owned banks for their working capital means that the banks are forced to satisfy contradictory objectives: financing employment and social stability while transforming themselves into commercially viable corporate entities. \footnote{See, Dobson & Kashyap, \textit{supra} note 5.}

In other words, NPLs are an inevitable result of the state’s continued ownership of banks. While the complete eradication of NPLs may not be possible, this Note suggests in Part III that better management of NPL’s risks could be achieved through a well-regulated process of securitization.

Despite this persistent problem, Chinese banks have made tremendous progress in both efficiency and global integration. The
third and most successful reform approach that China’s authorities have undertaken involved the contribution of capital and banking governance expertise by strategic foreign investors.\textsuperscript{76} Since China’s entry into the World Trade Organization, foreign investment in the Big Four increased quickly to $14.8 billion in 2004-2005.\textsuperscript{77} But Chinese law still places restrictions on foreign ownership in banks\textsuperscript{78} and thus the world banking community demands further liberalization. Nevertheless, increased foreign ownership in Chinese banks has led to higher quality bank management.\textsuperscript{79} A recent study of Chinese banks’ profit efficiency found that the Big Four are the least efficient banks in terms of cost and revenue performance,\textsuperscript{80} and by comparison, banks with minority foreign ownership have “almost a 20 percentage point higher profit efficiency level . . . and almost a 30 percentage higher profit efficiency rank.”\textsuperscript{81} So foreign investment in Chinese banks can help decrease the level of non-performing loans as a result of better management.\textsuperscript{82}

The last aspect of the recent banking reform is the listing of Chinese banks on foreign stock exchanges.\textsuperscript{83} Initial public offerings of Chinese banks have been successful in raising billions of dollars.\textsuperscript{84} For example, the CCB’s public offering in October 2005 raised $8 billion, the BOC raised $11.2 billion in June 2006, and the ICBC raised a record of $21.9 billion in October 2006.\textsuperscript{85} These IPOs opened Chinese banks to scrutiny and pressure bank directors and managers to increase profitability and focus on maximizing return on assets.\textsuperscript{86}

The development of the PBC as China’s central bank is a huge accomplishment worth noting. Prior to his departure in October 2007, Zhou Xiaochuan served as the head of the People’s Bank and oversaw major liberalization within China’s banking industry.\textsuperscript{87}

\textsuperscript{76} Id. at 8.  
\textsuperscript{77} Id.  
\textsuperscript{78} See discussion in Part II.D, infra.  
\textsuperscript{79} Berger, Hasan & Zhou, supra note 56, at 21-23.  
\textsuperscript{80} Id.  
\textsuperscript{81} Id. at 23.  
\textsuperscript{82} Id.  
\textsuperscript{83} Dobson & Kashyap, supra note 5, at 9.  
\textsuperscript{84} Id.  
\textsuperscript{85} Id.  
\textsuperscript{86} Id.  
From 2002 to 2007, Zhou permitted increased foreign competition and strengthened the Yuan by allowing it to fluctuate slightly against other currencies.\(^{88}\) In stark contrast to the inflation crisis of 1993, the PBC under Zhou used interest rate adjustments to curb inflation and weather various financial instabilities.\(^{89}\) Zhou’s departure comes as Chinese banks are reporting record profits, yet the fear of financial instability accompanies every step of the recent growth.\(^{90}\) The fate of the PBC, and specifically the degree of their independence from the central government, is now up in the air.

4. Current Woes

It is unclear how effective China’s recent reform-attack on non-performing loans has been. The studies on the effects of the three-staged reform described above have been somewhat contradictory in result.\(^{91}\) Several commentators found improved efficiency and productivity in the Chinese banking sector.\(^{92}\) And a recent study conducted by Cardiff University Business School in the UK found that the NPL ratio in state-owned banks had dropped to 9.3 percent by 2006, an impressive improvement from 52.7 percent in 1997.\(^{93}\) Yet, a recent Congressional report stated that Chinese banks are still facing a portfolio of NPLs “conservatively estimated” at 30 percent or more.\(^{94}\)

So China’s state-owned banking system still struggles with a staggering amount of bad loans despite decades of reforms.\(^{95}\) China’s policymakers recognize the danger of these NPLs and have “leaned on bankers to curtail lending to particular industries deemed to be squandering investment . . . to avoid another upsurge in [NPLs].”\(^{96}\) But any efforts to curb NPLs must tread softly as such policies have broad economic effects, and the Chinese economy is currently

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\(^{88}\) Id.

\(^{89}\) Id.; see also Qian, supra note 9, at 483.

\(^{90}\) Leow, supra note 87.

\(^{91}\) Berger, Hasan, & Zhou, supra note 56, at 9.

\(^{92}\) See Matthews, Guo, & Zhang, supra note 13, at 2; Id. at 10.

\(^{93}\) Berger, Hasan, & Zhou, supra note 56, at 4.


\(^{95}\) See Chen, supra note 11, at 239.

\(^{96}\) Areddy, supra note 71, at A10.
battling rising interest rates, inflationary pressures, and an appreciating Yuan.97 Globally, the weak U.S. dollar and continued interest rate cuts by the U.S. Federal Reserve, mean Chinese exports could become expensive.98 The People’s Bank has to balance these global and domestic factors without raising interest rates to encourage lending sprees that feed runaway investments.99 The job of reforming the banks has gotten more difficult as the stakes become higher.

C. The Legal Framework: Chinese Banking Laws

China is a civil law country that operates more on standard practice than on law.100 China does not have a robust legal infrastructure or sophisticated legal banking frameworks, though China has passed special banking legislation to accommodate and facilitate the growth of a modern banking industry.101 In anticipation of its WTO entry, China passed two substantive banking laws, the PRC People’s Bank of China Law (the “Central Banking Law”) and the Commercial Banking Law.102

1. The Central Banking Law

In March of 1995, the 8th National People’s Congress enacted the Central Banking Law.103 The Central Banking Law established the legal framework and operational guidelines for the PBC to operate as China’s central bank.104 The PBC’s two major functions as the central bank are, first, formulating and implementing the government’s monetary policies, and, second, supervising the financial industry.105 Like other Chinese agencies, the PBC is designed to carry out its functions under the leadership of the State

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97 See Poon, supra note 2.
98 Id.
99 Id.
101 Id.
103 Qian, supra note 9, at 486.
104 Id.
105 Id.
Council and it must report to the Standing Committee of the National People’s Congress. However, the Central Banking Law allowed the PBC to control national monetary policy with economic and market-oriented mechanisms rather than pure administrative mandates. Since 1995, the PBC has successfully directed the country’s basic interest and foreign exchange rates, set deposit reserve standards, and managed the exchange rate. The Central Banking Law has been an important part of China’s banking reform and should be noted for its successes.

2. The Commercial Banking Law

The Commercial Banking Law was enacted in May 1995, and it is one of China’s most comprehensive pieces of banking legislation. This law outlines the establishment and application requirements for banks, as well as minimum registered capital requirements for commercial banks. The PBC has the power to approve new commercial banks. The Commercial Law also regulates commercial banks’ lending operations. Following the Glass-Steagall provisions of the United States, Chinese commercial banks are separated from investment banks and are prohibited from engaging in any trust investment or stock business. The Commercial Banking Law further demands that a bank examine a borrower’s purpose and repayment ability prior to making any loans. Banks are required to receive guarantees or collateral for each loan, and they enjoy certain legal rights upon default. In practice, however, Chinese banks are prone to lending sprees, which leads to concerns regarding the loan screening process and the repayment possibilities of these loans. Currently, pressure from both the central government and the market push Chinese

106 Id.
107 Id.
108 See Leow, supra note 87.
109 Lee, supra note 102, at 491.
110 Qian, supra note 9, at 488.
111 Id.
112 Id.
113 Wu, supra note 51, at 625.
114 Id.
115 Id.
116 See Areddy, supra note 71, at A13; Shih, supra note 3.
commercial banks to establish stricter processes to ensure higher quality loans and prevent the escalation of non-performing loans.117

D. Importance of Reform

One may question if banking reform is still relevant, given China’s economic boom and the record profit levels of Chinese banks. If the flawed banking system has gotten China this far, then perhaps the gradual adjustments made along the way will remain sufficient. This view ignores the importance of the banking system to an economy and the broader social effects of China’s financial sector reform efforts.

Despite its relatively more market-oriented approach (as compared with its past), the central government continues to guide the Chinese economy. This can cause unwise investments in unprofitable and unnecessary sectors.118 A recent U.S. Congressional report pointed out that, in China:

Easy credit available to state-owned firms or recently “privatized” firms in which the government still holds a significant stake and still influences management decisions has led to a boom in certain investments in heavy industry. When combined with the relative laxity with which Chinese state-owned banks demand repayment from such firms, the system overall has produced considerably greater investment in certain capital-intensive industries than might otherwise have been warranted if credit practices were such that they accurately gauged the risk and likely return of the proposed investments . . . . 119

An example of such unwise investment is China’s steel industry.120 China poured vast sums of money into expanding its steel producing capacity at a time when worldwide steel production was in excess.121 Chinese manufacturers could have satisfied their

117 Id.
118 Aldonas, supra note 94.
119 Id.
120 Id.
121 Id.
steel demand at a lower cost by relying on existing steel plants. 122 An independent banking industry that discriminates more when making loan decisions would likely have avoided such economic waste. China’s state-owned banks lack this independence and yield to the central government’s lending demands, which are often more policy than profit driven. 123 Further banking reform is necessary to liberate Chinese banks, to guard against poor economic planning, and to efficiently allocate financial resources.

A stable and strong banking industry is also paramount for social and political stability in China. 124 Despite the recent influx of Western consumerism, the Chinese culture continues to encourage saving and thrifty living. China’s domestic savings rate remains impressively high at nearly 50 percent, 125 around $1.113 trillion of the $2.512 trillion Chinese economy. 126 One can imagine the devastating economic impact and social instability that would result if Chinese citizens lost confidence in their banking system. If a bank run were to occur, the system would collapse and the central government would take the blame. 127 Such dangers are not far-fetched if Chinese banks continue to lend money without adequate risk assessment, 128 especially in view of the existing non-performing loan problem. So it is not surprising that Standard & Poor’s rated China’s banking industry as having moderately-high risk. 129

Finally, the last topic of concern is China’s uneven economic development between the coastal cities and the western provinces. While coastal cities like Shanghai have become comparable to other world metropolises in wealth and glamour, “life farther west in China almost belongs to another time in China, one in which peasants engage in near subsistence farming and what employment exists in local factories is still subject to significant oversight, if not control, by local party officials.” 130 The heavy disparity has caused aggressive, sometimes violent, protests in China. 131 The country’s

122 Id.
123 Dobson & Kashyap, supra note 5.
124 Aldonas, supra note 94.
125 See discussion in Part II, infra.
126 Aldonas, supra note 94.
127 Id.
128 Shih, supra note 3; China Corruption Bank, supra note 3.
129 McCullough, supra note 7, at 426.
130 Aldonas, supra note 94.
131 Id.
political and social stability rests on resolution of this uneven economic development.\footnote{132} The current banking system contributes to the disparity.\footnote{133} State-owned banks operate under a statutorily regulated rate of return on savings, which makes it unprofitable to invest in rural areas.\footnote{134} Further banking reform is necessary to correct these distorted incentives and to alleviate this difference in geographic wealth. Without such reform, China faces great social volatility.

To balance the banks’ desire to maximize profit and the necessity of rural development, Chinese banks must find a solution to the NPLs problem. Given the difficulty of eliminating NPLs, the next-best alternative is efficient management. One possible way to achieve better risk management is through securitization.

\section*{III. Asset-Backed Securitization in China}

Securitization is a recent development in the financial world. When done correctly, it offers a way to disperse risk among many investors.\footnote{135} Securitization has become a major part of any developed financial market and attracts trillions of dollars.\footnote{136} Following the theme of gradual banking reform, China is slowly developing an asset-backed securitization market.\footnote{137} Since passing the first law endorsing asset-backed securitization in 2005, a complex legal framework in this area has emerged in China.\footnote{138} Commentators believe asset-backed securitization may help China manage state-owned banks’ non-performing loans.\footnote{139}

Regulations on asset-backed securitization, like many of China’s modern banking and financial laws, draw significantly from other developed markets, especially the U.S.’s.\footnote{140} The recent crisis in U.S. mortgage-backed securities has turned the spotlight on this important, yet largely unregulated industry. It is in China’s best

\begin{itemize}
\item \footnote{132} Id.
\item \footnote{133} Id.
\item \footnote{134} Id.
\item \footnote{135} Weiner, supra note 100.
\item \footnote{137} See, Weiner, supra note 100, at 233.
\item \footnote{138} Id.
\item \footnote{139} Id. at 228.
\item \footnote{140} Id.
\end{itemize}
interest to absorb the lessons from the U.S. as it develops its regulatory framework on securitization.

A. Securitization of Debt

An asset-backed security is defined as:

a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the securityholders . . . .

This definition outlines the process and the key components of debt securitization, which has three components: a pool of non-liquid assets, a specially created investment vehicle issuing bonds backed by the assets, and investors who purchase such bonds. Any assets with a steady revenue stream can be pooled and securitized. Examples of such assets include credit cards, automobile loans, and home equity loans. The earliest form of securitization was in mortgage backed securitization and mortgages are still the most

142 For additional assistance, the Comptroller of Currency has defined: “[a]sset securitization is the structured process whereby interests in loans and other receivables are packaged, underwritten, and sold in the form of ‘asset-backed’ securities. From the perspective of credit originators, this market enables them to transfer some of the risks of ownership to parties more willing or able to manage them. By doing so, originators can access the fund markets at debt ratings higher than their overall funding sources at more favorable rates. By removing the assets and supporting debt from their balance sheets, they are able to save some of the costs of on-balance-sheet financing and manage potential asset-liability mismatches and credit concentrations.” Asset Securitization, Comptroller’s Handbook, Comptroller of the Currency Administrator of National Banks (Nov. 1997), available at http://www.occ.treas.gov/handbook/assetsec.pdf [hereinafter Comptroller’s Handbook].
143 See Wei, supra note 100, at 226-227.
144 WILLIAM D. WARREN & STEVEN D. WALT, COMMERCIAL LAW, 162 (Foundation Press, 7th ed., 2007).
145 Unterman, supra note 136, at 79.
securitized asset.\textsuperscript{146} Cash flows from the underlying assets generate payments to investors.\textsuperscript{147} The special purpose vehicle (the “SPV”), sometimes called the securitizers, purchases these cash generating assets.\textsuperscript{148} The SPV issues bonds backed by the pooled assets and thus convert the previously non-liquid assets into a liquid asset.\textsuperscript{149} Indeed, the ability to boost a bank’s liquidity is the primary benefit of securitization.\textsuperscript{150} Finally, institutional or similarly sophisticated investors purchase the asset-backed securitized bonds issued by the SPV.\textsuperscript{151} In exchange for the bond’s rate of return, the investors assume the risk of default on the underlying assets.\textsuperscript{152} The significance of this risk is worth emphasizing because these bonds either meet the expected performance or suffer a loss.\textsuperscript{153} Asset backed securities are backed by fixed income assets, the principal and interest of which are either successfully repaid or default.\textsuperscript{154} Despite such risks, large institutional investors continue to willingly assume these risks for a commensurate high rate of return. Also, the payment streams of securitized assets are often broken into tranches reflecting the priority of payment, so not only is risk and return diversified but it is also structured.

Aside from the three key components, there are other factors involved in the securitization process. The expertise and knowledge that ratings agencies have is essential for pricing the securities.\textsuperscript{155} Risk analysis and allocation are paramount for any investment. Because the underlying assets are purchased from varying sources, the resulting pooled asset is often extremely complex and can be difficult to analyze.\textsuperscript{156} The investors, the market, and the regulators rely on rating agencies for their unbiased and accurate analysis. And the industry’s regulators play an important role.\textsuperscript{157} The U.S.

\begin{footnotesize}
\textsuperscript{146} Warren & Walt, supra note 144.
\textsuperscript{147} Wei, supra note 100, at 227.
\textsuperscript{148} Unterman, supra note 136, at 86.
\textsuperscript{149} Id.
\textsuperscript{151} Unterman, supra note 136, at 86.
\textsuperscript{152} Id. at 79-80.
\textsuperscript{153} Id. at 80.
\textsuperscript{154} Id.
\textsuperscript{155} Id. at 81.
\textsuperscript{156} Id.
\textsuperscript{157} Id. at 93-95.
\end{footnotesize}
subprime crisis unveiled the bleak fact that this trillion dollar industry remains largely unregulated and bad lending practices had become germane to the assets being securitized, and thus unseen risk accumulated.\textsuperscript{158} Therefore, comprehensive laws and effective regulatory schemes are essential for China’s developing securitization market to avoid this kind of result.

\textbf{B. United States: The Rise and Fall of the Mortgage Backed Securities}

Mortgage-backed securitization is the earliest and the primary type of asset-backed securities, and beginning in 2007, that market met head on with crisis.\textsuperscript{159} The pooled assets in mortgage-backed securities are real estate loans.\textsuperscript{160} One type of loan commonly pooled is the subprime mortgage. Subprime mortgages are tailored for a class of borrowers with limited or poor credit history and thus are more likely to have difficulty repaying their loans.\textsuperscript{161} As a result, subprime mortgages carry greater risks. The risk of default on these mortgages is passed from the mortgage originators to securitizers such as investment banks and government sponsored enterprises.\textsuperscript{162} The bonds issued by the securitizers are then purchased by institutional purchasers such as pension funds and insurance companies.\textsuperscript{163} All three parties mentioned above, together with the rating agencies and the regulators, contributed to the subprime crisis.

The subprime crisis is largely the result of investors’ failure to understand the risk in mortgage-backed securities—whether because of willful blindness or they were tricked. Prior to securitization, the mortgage originators themselves bore the risk of default.\textsuperscript{164} The mortgage originators had the incentive to carefully screen borrowers to protect against defaults.\textsuperscript{165} However, through the process of mortgage-backed securitization, this risk is passed on to investment banks, hedge funds, or government sponsored

\textsuperscript{158} Id.  
\textsuperscript{159} Wei, \textit{supra} note 100, at 227.  
\textsuperscript{160} Id.  
\textsuperscript{161} Unterman, \textit{supra} note 136, at 84.  
\textsuperscript{162} Id. at 86.  
\textsuperscript{163} Id.  
\textsuperscript{164} Id. at 84.  
\textsuperscript{165} Id.
agencies. Because the mortgage originators’ profit increased with the number of loans sold to securitizers, the incentive to actively screen borrowers decreased. Mortgage lenders competed for borrowers rather than the other way around. Yet the economic boom and the general housing bubble prior to the collapse gave investors false confidence in these securitized loans. Although securitization allows both the structuring of payments and the diversification of risk, the race to the bottom reduced the overall quality of the assets so that no one was safe from mass default. Investors believed that government sponsored enterprises were “too big to fail,” and due to their sheer size, the federal government would never allow such organization to collapse. Whether “too big to fail” holds true or not, investors’ reliance on the concept contributed to the market failure. Other factors such as increasing oil costs also led to a general slowdown of the US economy. Borrowers started defaulting on their loans. In fact, subprime mortgages currently account for over one trillion dollars and the past due rate on these mortgages is over thirteen percent. As one commentator observed:

Securitization perpetuated the U.S. housing bubble and resulting malfeasance within the mortgage finance industry. The harm created by irresponsible and fraudulent actions will be felt by the U.S. housing industry, the economy, and foreign investors. The downturn of the U.S. housing market will expose the need for greater regulation and oversight of global debt market.

Asset-backed securitization developed quickly and remains unregulated despite its size and importance. The market was expanded to reflect supply and demand, yet we now know, with hindsight, that the market did not have sufficient information regarding these loans’ composition nor risks. The U.S. government

166 Id.
167 Id.
168 Id. at 87.
169 Id.
170 See, e.g., Peter A. McKay, Stock Market Loses Ground Under Pressure From AIG, Oil, WALL ST. J., May 9, 2008.
171 Unterman, supra note 136, at 95.
172 Id. at 99.
will probably regulate this area further and other countries are likely to follow suit.

C. China: NPLs and Asset-Backed Securities

The U.S. subprime crisis has significantly affected Chinese banks. Banks that held U.S. subprime investments felt the shock directly. The Bank of China, one of the largest Asian financial institutions to invest in securities backed by U.S. subprime mortgages, is expected to write off a quarter of $8 billion in securities. Other large state owned Chinese banks face similar problems, though their subprime mortgage holdings are not as significant. In recent years, Chinese banks have been highly profitable and have played a large part in sustaining China’s growth. So the effect of significant write-downs on the Bank of China’s profits is troublesome. A shock of this magnitude renews serious worries of the non-performing loans.

Investors are particularly interested in how the U.S. subprime crisis will affect the development of asset-backed securitization law in China. As the mortgage loan business rapidly expands, the Chinese government is passing securitization laws and regulations. There are many possible benefits of utilizing asset-backed securitization as a potential solution to the non-performing loan problem. One commentator writes:

[T]he perceived benefits of asset-backed securitization include: (1) supporting public policy objectives such as broad home ownership and the

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174 Id.
175 Id.
176 See, Areedy, supra note 71.
177 Leow & Areedy, supra note 173.
178 Id. But some economists are taking a more optimistic view. China’s economic growth in recent years means Asia is less dependent on the U.S. and E.U. economy. Indeed, “[t]his economic downturn will mark the first time that when American sneezes, Asia doesn’t catch a cold. Yes Asia will be affected, but not as severely. Because China and India will not experience a recession.” Lee Kuan Yew, Asia’s Growing Role in Financial Markets, FORBES, Feb. 25, 2008.
179 See, Wei, supra note 100, at 233.
development of financial markets, especially capital and mortgage markets; (2) addressing regulatory requirements for financial institutions, especially capital adequacy and lending limit requirements applicable to banks; (3) transferring risk, especially in the context of non-performing assets and portfolio diversification; and (4) providing finance.\textsuperscript{180}

Specifically for China, asset-backed securitization can be immensely helpful in risk management for state owned banks’ NPLs.\textsuperscript{181} Yet as beneficial as securitization can be, the danger is also great.

\textbf{D. Could a Similar Housing Bust Occur in China?}

There are inherent differences between both the U.S. and Chinese economies and their banking systems. Some of these differences may shield China from risks faced by the U.S., but others may make the danger of securitization even graver in China. First, while mortgage-backed securitization represents the majority of the securitized bonds in the U.S., Chinese banks are less interested in securitizing mortgage loans.\textsuperscript{182} Chinese banks do not face the same liquidity pressures as American banks do because Chinese banks are limited mechanisms for investment and most citizens deposit their savings in banks.\textsuperscript{183} Further, banks in China are less likely to sell mortgage loans to securitizers because they prefer to sell securitized mortgage loans to their customer state-owned enterprises.\textsuperscript{184} Unlike in the U.S., where the mortgage originator completely passed the risk of default to investment banks and government sponsored enterprises, Chinese banks retain some risk because the securitized mortgage loans are sold to affiliated customers.\textsuperscript{185} The incentive to screen the applicant is still present due to the government’s practice of policy lending. If the affiliated SOEs run into financial troubles, the central government would direct the banks to make policy loans. Thus, it is in the interest of the banks to ensure the mortgage loans are low risk. Lastly, the purpose of mortgage backed securitization is

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{180} \textit{Id.} at 228 n.21.
\item \textsuperscript{181} \textit{Id.} at 228.
\item \textsuperscript{182} \textit{Id.}
\item \textsuperscript{183} \textit{Id.} at 231.
\item \textsuperscript{184} \textit{Id.}
\item \textsuperscript{185} \textit{Id.}
\end{itemize}
\end{footnotesize}
different for Chinese banks. As observed by one commentator: “China has a specific agenda in securitization. The goal is improving the economic performance and efficiency of its commercial banks by securitizing their non-performing loans.” In this respect, the securitization process is more similar to the failed AMCs than its American counterpart. These differences between the U.S. and China make a housing bust unlikely to occur in China. Nevertheless, the recent U.S. subprime mortgage crisis provides significant lessons for China in developing its securitization laws.

E. China’s Securitization Laws

China has been developing its securitization market since the 1990s. On April 20, 2005, the People’s Bank of China and China Banking Regulatory Commission (“CBRC”) promulgated the Administrative Rules for Pilot Securitization of Credit Assets (the “Rules”). This was China’s first law supporting asset-backed securitization. As stated in a joint announcement from PBC and the CBRC, the Rules are intended to “regulate the pilot securitization of credit assets, protect legitimate interests of investors and relevant involved parties, improve the liquidity of credit assets and enrich securities products.”

Prior to the Rules, the Chinese legal system could not accommodate securitization projects because it was unlawful for SPVs to hold assets and issue securities. The Rules and the two pilot credit asset securitization projects subsequently approved by the State Council were the long-awaited answer to the international banking community’s demand. The Rules are comprehensive in outlining the requirements and duties of parties involved in securitization, as well as the process for issuing and trading asset-

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186 Id.
187 Id. at 240.
188 Id. at 243.
191 People’s Bank of China Announcement, supra note 189.
192 Ramel, de Meaux-Beceleivre, & Qian, supra note 190.
193 Id.
backed securities in national inter-bank bond markets.\textsuperscript{194} And the Rules resulted from the efforts of ten regulatory authorities under China’s State Council.\textsuperscript{195} Thus, they do not carry the same authoritative weight as the national laws passed by the National People’s Congress.\textsuperscript{196} National laws, namely China’s Contract Law, Bankruptcy Law, Company Law, and Trust Law are supreme and will preempt the Rules when there is a conflict between them.\textsuperscript{197} This is a cause for concern because some national laws do not fully support securitization.\textsuperscript{198} The impact of such conflicts is examined in full detail below.

To facilitate the comparison between the Rules and the U.S. mortgage-backed securities, this Note examines the Rules in the same order as the three components listed above: pools of non-liquid assets, a specially created investment vehicle that issues bonds backed by the assets, and the investors who purchase the bonds. First, the Rules only allow the securitization of “credit assets.”\textsuperscript{199} The Rules do not define “credit assets” and commentators are uncertain whether different types of receivables are included.\textsuperscript{200} PBOC informally defined “credit assets” as “assets that can be identified and recorded on an originator’s balance sheet as credit assets requiring risk capital allocation (such as loans and receivables) . . . im[p]ly[ing] that it is not currently possible to securitize unidentified receivables.”\textsuperscript{201} According to the Rules, the state owned banks are the “originators” of the securitization of credit assets.\textsuperscript{202} Indeed, only banks can be originators under the Rules;\textsuperscript{203} “[a]n originator of the securitization of credit assets refers to a financial institution which transfers credit assets . . . .”\textsuperscript{204} Such limitation on who can be an originator of securitized assets can be an advantage in light of the U.S. mortgage crisis. As pointed out in Subsection III.D, above, Chinese banks cannot completely transfer away the risk of the default

\begin{footnotesize}
194 People’s Bank of China Announcement, supra note 189, art. 1.
195 \textit{Id.}
196 \textit{Id.}
197 \textit{Id.}
198 \textit{Id.}
199 Id. at art. 2; see also, Ramel, de Meaux-Becdelievre, & Qian, supra note 190.
200 Wei, supra note 100, at 238.
201 Ramel, de Meaux-Becdelievre, & Qian, supra note 190.
202 People’s Bank of China Announcement, supra note 189, at art. 11.
203 \textit{Id.} at art. 2.
204 \textit{Id.} at art. 11.
\end{footnotesize}
through securitization because banks are state-owned and have SOEs as repeat customers. Both de facto and de jure, the Chinese securitization market does not allow originators to completely transfer away risk of loan defaults as U.S. mortgage originators can.\footnote{See, Unterman, supra note 136, at 85.} This limitation provides stability and accountability in China’s asset-backed securitization market.

Further, the Rules emphasize the “true sale” nature of the underlying asset held for the purpose of securitization.\footnote{People’s Bank of China Announcement, supra note 189, art. 6.} The Rules state:

\[\text{the entrusted property shall be the credit assets transferred to a trustee through trust commitment, which is independent of the assets owned by the originator, trustee, loan servicer, fund depository institution, securities registration and custodian unit or other agencies involved in the transaction . . . . When [the above parties] involved in transactions are liquidated due to dissolution, closure or declaration of bankruptcy according to the law, the entrusted property shall not be included in the assets to be liquidated.}\footnote{Id.}

Although the Rules clearly declare remoteness of the pooled assets in case of bankruptcy, Chinese bankruptcy law still contains substantial restrictions on the transfer of financial assets for securitization purposes.\footnote{Schetman, Jean & Wang, supra note 150, at 4.} The supremacy of the bankruptcy law over the Rules is a question of concern for China’s securitization market.\footnote{Ramel, de Meaux-Bececlievre, & Qian, supra note 190.} This concern is heightened because a major goal of securitization in China is dealing with state-owned banks’ non-performing loans. The NPLs are the credit assets being pooled here. Thus, it is imperative to establish a clear legal distinction between non-performing loans and the banks’ other performing assets. Further, if banks go into bankruptcy, the law must protect the transferred assets to protect the stability of the securitization market itself. This is an area that requires further legislation and clarification.
An originator’s duty to make public announcements is another point of conflict between the Rules and other laws. Under the Rules, an asset-backed security is not valid until the originator publicly announces the assignment in the national media. This requirement conflicts with China’s Contract Law, under which such public announcements are not valid for creditors who wish to effectively assign contract rights to third parties. Because China’s Contract Law has priority over the Rules, traditional contract notice requirements apply to asset-back securitization, and the PBOC does not have the authority to interpret or alter the Contract Law. However, PBOC cites inefficiency and high administrative cost as reasons for the Rules’ departure from the Contract Law. PBOC anticipates that the Supreme People’s Court would validate such public announcements in the context of securitization. This conflict demonstrates the need for further regulation or legislative amendment. Commentators have suggested that it may be prudent to serve written notice to each debtor to ensure the validity of the assignment until the conflict is resolved.

The second component of the securitization process is an SPV that issues bonds backed by the pooled assets. The Rules state that SPVs are trusts and only trustees of these SPVs can issue asset-backed securities. Assets are transferred from the originator to the trust via a trust contract, and the Rules dictate the contents of the trust contract. And China’s Company Law prevents a company from becoming an SPV. The Company Law sets high standards on the amount of registered capital for the creation of limited liability companies (“LLCs”) and even higher net asset requirements for limited liability partnerships (“LLPs”) issuing bonds. This

210 Schetman, Jean & Wang, supra note 150, at 4.
211 People’s Bank of China Announcement, supra note 189, art. 12.
212 Schetman, Jean, & Wang, supra note 150, at 4.
213 Id.
214 Id.
215 Id.
216 See id.
217 Id.
218 People’s Bank of China Announcement, supra note 189, art. 3.
219 Id. art. 13.
220 Wei, supra note 100, at 234.
221 Id. According to the Company Law, a limited liability company should have at least RMB 30,000 registered capital, and a joint stock company must have at least RMB 5,000,000. Chinese Law also stipulates that the
effectively prevents companies from acting as SPVs in China. In comparison, an SPV in the U.S. can be an LLC created for a special purpose, a trust, or an existing corporation. China’s limitations on the SPV form restrict the growth and development of its securitization market. Of course, the U.S. mortgage crisis demonstrated, at least to some extent, a general securitization regulation failure, and the flexibility under the U.S. system may have contributed to its own failure. In comparison, limiting the specially created investment vehicles to trust form, where the trustees have certain standards of duties and care, may be a beneficial safeguard against imprudent risk taking.

The third component in the securitization process is the issuance and trading of asset-backed securities. The Rules specify the process for issuing asset-backed securities. Such securities qualify as negotiable securities and can only be traded on the Chinese National Interbank Bond Market (the “NIBBM”). The trustee must satisfy the initial application requirement to the PBC prior to issuing asset-backed securities and the PBC reserves the right to accept or deny the application within five days of its receipt. The decision is based on the trustee’s prospectus and credit rating reports. Since the passage of the Rules in 2005, the State Council has approved two regulated pilot projects of credit asset securitizations. On issuance of debentures or bonds requires that the net assets of a limited liability company be at least RMB 60,000,000, while the cumulative value of debentures or bonds must not exceed 40% of the company’s net assets.

222 Id.
223 Id.
224 See, e.g., Unterman, supra note 136.
225 The Rules list various duties of the trustee. A good examples of such a duty comes from Article 47, which states that “[a] trustee shall remind the investors in a noticeable place of the prospectus that ‘the asset-backed securities represent only the corresponding shares of the beneficial rights of a special purpose trust, not the liabilities of the originator of the securitization of credit assets, the trustee of special purpose trust or any other institution. The right of recourse of the investment institution is only limited to the entrusted property.’” People’s Bank of China Announcement, supra note 189, art 47.
226 Id.
227 Id. art 3.
228 Id.
229 Id.
230 Ramel, de Meaux-Becdelievre, & Qian, supra note 190.
December 9, 2005, the China Construction Bank (the “CCB”) project—a RMB 2.9 billion ($360 million) issuance of mortgage-backed securities was approved. Furthermore, on December 12, 2005, the approval of the China Development Bank (the “CDB”) project—a RMB 4.2 billion ($500 million) issuance of asset-backed securities (involving infrastructure loans in the telecommunications, energy, utility, and transportation industries) followed.

There are concerns, however. One contributing factor in the U.S. subprime crisis was investors’ false belief that government sponsored enterprises like Freddie Mac and Fannie Mae were “too big to fail.” Investors failed to take account of the high risk of the underlying obligations, such as subprime mortgages, and instead used the special relationship between Fannie Mae and Freddie Mac and the government as a measure of risk. The possibility of similarly undervaluing the risk also exists in China. The close relationship between the central government and the state-owned banks is well documented, and the central government has repeatedly pumped large sums into state-owned banks to rebuild their capital bases. This history of reliance, combined with current ambiguity over the “true-sale” of assets caused by incongruity between the Rules and China’s Bankruptcy Law, creates an atmosphere similar to that in the U.S. Therefore, there is a risk that the asset-backed securities in China can be misrepresented as they were in the U.S.

Finally, the Rules require unbiased reviews of asset-backed securities by credit rating agencies both before and after the securities are issued. But the Rules do not specify qualifications for credit rating institutions. As evidenced by the failure of the credit rating agencies in the U.S. to adequately assess risks and the assignment of inflated investment grades to subprime mortgage assets, it has become self-evident that rating agencies’ independent and accurate review is essential for the securitization market to

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231 See id.; Schetman, Jean & Wang, supra note 150, at 1.
232 Ramel, de Meaux-Becdelievre, & Qian, supra note 190. Little has been written about how these two projects have fared since issuing their asset-backed securities two years ago.
233 Unterman, supra note 136, at 87.
234 Id. at 88.
235 See Chen, supra note 11, at 251; Dobson & Kashyap, supra note 5.
236 People’s Bank of China Announcement, supra note 189, art 35.
237 See Wei, supra note 100, at 237.
Therefore, it is important for the PBC and the CBRC to pass legislation to fill this gap in regulation and place safeguards against similar failure.

F. Alternative Forms of Securitization?

Given the incomplete and sometimes conflicting nature of China’s burgeoning securitization regulation, some commentators have suggested synthetic collateralized debt obligations (“CDOs”) as an alternative to full asset-backed securitization. This section follows the three-component analysis for comparing and understanding synthetic CDOs. First, the key difference between synthetic CDOs and traditional asset-backed securities are in their underlying pooled assets. Instead of traditional pools of assets, like bonds and loans, pools of credit derivatives include instruments like credit default swaps, forward contracts, and options.

The second component of a synthetic CDO is the SPV that issues bonds. In the case of synthetic CDOs, the originator transfers the credit risk of the financial assets to an SPV without a true sale of such financial assets. Instead, the SPV uses a credit derivative instrument to sell credit protections to the originator. The value of the pooled asset depends on its credit quality, assigned by an independent credit rating agency. Further, the credit quality of the pooled asset changes upon the occurrence of a credit event defined in the credit derivative instrument. Unlike traditional securitization where the SPV purchases underlying assets from originators, the originators of synthetic CDOs pay the SPV a premium in exchange for credit protection and for SPV’s assumption of risk. The SPV, in turn, makes payments to the originator upon the occurrence of a pre-determined credit event. And investors, the third and final component, function similarly here as under traditional

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238 Unterman, supra note 136, at 90-91.
239 Schetman, Jean & Wang, supra note 150, at 1.
240 Id.
241 Id.
242 Id.
243 Id.
244 Id.
245 Id.
246 Id.
The SPV passes credit risk to investors, and investors assume the risk because the synthetic CDOs offer extremely high yields.\footnote{Id.} Synthetic CDOs may be a desirable alternative to traditional asset-backed securities in China because of the current limitations in Chinese securitization law.\footnote{Id.} Conflicts between China’s Contract Law and Bankruptcy Law and the Rules on Securitization cause uncertainty and operational inconvenience.\footnote{Id. at 3.} By avoiding the “true sale” aspect of traditional securitization, the SPV avoids the bankruptcy issues of substantive consolidation and the Contract Law requirement of notification prior to assignments.\footnote{See, Wei, supra note 100, at 237; Ramel, de Meaux-Becdelievre & Qian, supra note 190, at 3.} Further, because synthetic CDOs are a “pure play on credit,” they allow Chinese banks to isolate the credit risk of loans from other risks, such as market risk, interest rate risk, currency risk, and liquidity risk.\footnote{See, Wei, supra note 100, at 237; Ramel, de Meaux-Becdelievre & Qian, supra note 190, at 3.} This allows banks to more effectively pass this specific risk to the sector of the capital markets best able to bear it, leading to more efficient risk transfer and banking system.\footnote{Id.}

Despite the various advantages of synthetic CDOs, these instruments carry complex risks due to their advanced and complicated structures.\footnote{Unterman, supra note 136, at 82.} The U.S. mortgage crisis offers a great example of CDOs’ inherent dangers. Indeed, one commentator likened holding CDOs to “Russian roulette”:

> The complexity of CDOs masks and misrepresents risk transfers through an opaque grading system which combines investment pools with different risk

\footnote{247 Id. \footnote{248 Id. \footnote{249 Id. at 3. \footnote{250 See, Wei, supra note 100, at 237; Ramel, de Meaux-Becdelievre & Qian, supra note 190, at 3. \footnote{251 See, Wei, supra note 100, at 237; Ramel, de Meaux-Becdelievre & Qian, supra note 190, at 3. \footnote{252 “Credit risk is the risk to earnings or capital arising from an obligor’s failure to meet the terms of any contract with the bank or otherwise to perform as agreed . . . . It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreement, whether on or off the balance sheet.” Comptroller’s Handbook, supra note 142, at 37. \footnote{253 Schetman, Jean, & Wang, supra note 150, at 3. \footnote{254 Id. \footnote{255 Unterman, supra note 136, at 82.}}}}}}
exposures. However, credit risks do not disappear and are simply shifted to other areas of the market. There is increasing concern that investors may be unaware of the risks associated with these investments and find themselves incurring losses based on representations made by securities issuers. The complexity and lack of transparency of securitized assets has allowed investor ignorance to be manipulated for profit and this will likely be reflected in widespread securities litigation.256

The potential of hiding risk from investors is magnified in China because the securitization market is still young and developing.257 A mature system of credit rating agencies is not yet in place and more regulation is necessary in China. Given the credit rating agencies’ key role in the valuation of synthetic CDOs, risk of irresponsible behavior is heightened in China.

IV. Conclusion

Debt securitization is an important part of a well developed financial market,258 and is an effective way to allocate risk and address banking industries’ various concerns. But the U.S. subprime and housing crisis made it clear that securitization—like other markets—is prone to abuse and failure, especially given the fact that it is currently largely unregulated.259 All these securitization risks are magnified in the young and developing Chinese market. Coupled with the fragility of China’s banking system, a shock like the U.S. subprime crisis to China would likely cripple the economy. At the same time, the youth of the market system presents a tremendous opportunity to develop a truly sophisticated securitization market. The U.S. invented the securitization market, and China has the U.S.’s examples—both good and bad—to learn from. An effective solution to China’s non-performing loan problem would be for China to incorporate the lessons learned from the U.S. subprime crisis and

256 Id.
257 See Wei, supra note 100, at 237; Ramel, de Meaux-Becdelievre & Qian, supra note 190, at 3.
258 Wei, supra note 100.
259 Unterman, supra note 136.
translate them into effective regulations and an efficient structure for its asset-backed securitization system.

The first step for China is to resolve the conflicts between the Administrative Rules for Pilot Securitization of Credit Assets and the Chinese Contract Law, Bankruptcy Law, Trust Law, and Company Law. A comprehensive and mutually supportive (and internally consistent) legal framework is essential for a successful financial and securitization market. Good frameworks engender certainty and investor confidence. Further, China needs to develop monitoring and regulatory vehicles to ensure the integrity of any credit rating system. Failure and ignorance among mortgage originators, securities issuers, credit agencies and investors’ created the market failure in the United States. China cannot rely on the market to regulate itself. Rather it must exert control mechanisms to ensure that risk is adequately valued, disclosed, and understood by all three components of securitization. Here, China’s tradition of a planned economy and the central government’s close reign on the banking and financial industry might be beneficial. There are no easy solutions to a problem as complex as Chinese banking reform. Proceed carefully and cautiously.