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# Securitisation

China

Trends and Developments

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Global Law Office

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## Trends and Developments

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From the legal perspective, 2020 was the most important year in the history of China's securitisation market. On 1 March 2020, the most recently revised Securities Law promulgated by the National People's Congress (hereinafter referred to as "the new Securities Law") came into effect. This amendment unequivocally provides that the general principles of the new Securities Law are applicable to the offering and trading of asset-backed securities. On 28 May 2020, the National People's Congress deliberated and passed the Civil Code of the PRC, which will come into force on 1 January 2021. The Civil Code has made substantial amendments to several important legal matters involved in asset-backed securitisations, such as the assignment of creditors' rights, the registration of security interests and types of transferable debt. Another milestone in 2020 was the efforts of the China Securities Regulatory Commission (CSRC) and the National Development and Reform Commission (NDRC) to promote the development of China's REITs market by virtue of asset-backed securities. However, on the current pilot programme, the only REITs product available for offering is the infrastructure-based REIT.

### **Integration between the New Securities Law and the Legal System of China's Asset-Backed Securities**

China's asset-backed securities market has evolved into three parts: credit asset-backed securities, exchange asset-backed securities and asset-backed notes. Credit asset-backed securities, such as collateralised loan obligations (CLO) and residential mortgage-backed securities (RMBS), are securitisations of credit assets from commercial banks, financial leasing companies, auto finance companies and other financial institutions. Exchange asset-backed securities are supported by future cash flows and accounts receivable generated by the underlying assets of companies other than financial institutions. They are mostly traded in the Shenzhen Stock Exchange and the Shanghai Stock Exchange, subject to the regulations of the CSRC; as a result, they are usually referred to as "exchange asset-backed securities". The asset-backed notes are regulated by National Association of Financial Market Institutional Investors (NAFMII). There is not much difference between asset-backed notes and exchange asset-backed securities, except that the asset-backed notes are traded in the Chinese interbank market and governed by the People's Bank of China. According to the Rules for Identification of Standardised Debt-Based Assets issued by the People's Bank of China on 3 July 2020, the insurance asset-backed securities regulated by the former China Insurance Regulatory Commission are no longer viewed as asset-backed securities.

These three asset-backed securities are currently governed by different laws and regulations. The basic rules for the offering and trading of credit asset-backed securities are the Administrative Measures on the Pilot Programme for Securitisation of Credit Assets (promulgated by the People's Bank of China and the former China Banking Regulatory Commission in 2005) and the Measures for the Supervision and Administration of the Pilot Programme Securitisation for Credit Assets of Financial Institutions (promulgated by the former China Banking Regulatory Commission in 2005). The basic rules for the offering and trading of exchange asset-backed securities are the Administrative Provisions on Asset Securitisation of Securities Companies and Subsidiaries of Fund Management Companies (promulgated by the CSRC in 2014). The basic rules for the offering and trading of asset-backed notes are the Guidelines on Asset-backed Notes of Non-financial Enterprises issued by NAFMII in 2017.

It seems that the three market segments developing independently has played a positive role in promoting the development of China's asset-backed securities market in the short term. However, in the long term, it is likely to make the securitisation laws and regulations more complicated, and may even lead to regulatory arbitrage, which will cause market disruptions, especially with regard to the deterrence of international investors from China's asset-backed securities market. According to the new Securities Law, asset-backed securities, like stocks and bonds, shall comply with the new Securities Law, Article 2 of which specifically authorises the State Council to enact administrative measures for the offering and trading of asset-backed securities in accordance with general principles of the new Securities Law. The arrival of a uniform set of rules applicable to all three asset-backed securities market segments is eagerly awaited.

### **Huge Influence of the Civil Code of the People's Republic of China**

There is no doubt that the enactment of the Civil Code is the greatest national legislature scheme to date. On the date of implementation of the Civil Code, the Uniform Principles of the Civil Law, General Rules of the Civil Law, Contract Law, Property Law and Guaranty Law will be replaced, and some new legislation that has a great impact on asset-backed securities will also take effect.

## **Notice to Obligor of Assigned Creditors' Rights, Obligor's Consent to Assignments of Creditors' Rights and Offsetting**

Article 79 of the Contract Law provides that the creditor may assign its contractual rights to a third party in whole or in part, unless the parties have agreed that the rights may not be assigned. Therefore, in practice, a large number of account receivables cannot be assigned or securitised, because large-scale Chinese enterprises as obligors would usually stipulate in relevant contracts that their creditors shall not assign to any third party the accounts receivable arising out of sales of goods. In order to help more small and medium-sized enterprises to better engage in account receivables financing, Article 545 of the Civil Code provides that "where the parties agree that the monetary claims shall not be assigned, such an agreement shall not be enforceable against a third party." This leaves the door open for the corporate asset securitisation business of account receivables.

Article 80 of the Contract Law provides that the assignment "shall be notified to the obligor" and that "the assignment shall have no effect in relation to the obligor" where such notification is not provided. This article has caused great confusion to the assignors of creditors' rights. From the perspective of encouraging assignments of creditors' rights and promoting asset liquidity in the market economy, Article 546 of the Civil Code no longer requires the obligor to be notified of any assignment of creditors' rights, and only provides that "where the creditor assigns its claims without notifying the obligor, such assignment is not binding on the obligor."

Pursuant to Article 546 of the Civil Code, the assignment has no legal effect between the obligor and the assignor, nor between the obligor and the assignee where the assignment is not notified to the obligor, but is effective between the assignor and the assignee – ie, the assignee obtains the creditors' rights even if the assignment is not notified to the obligor. However, it should be noted that the defences and rights of offset that the obligor could assert against the assignor remain available against the assignee. In particular, Article 549 of the Civil Code provides that "under any of the following circumstances, the obligor may assert offsetting against the assignee: ... (II) the creditors' rights of the obligor and the assigned creditors' rights arise from the same contract." This new right of offset is not embodied in the existing Contract Law. It may bring some new legal risks to the securitisation of ordinary leasing, financial leasing and account receivables after 2020.

## **Registration of Change of Security Interests**

The provisions of the existing Property Law are ambiguous as to whether a change of the security interests holder must be registered when the creditors' rights are assigned. Judges and legal scholars have different views on this issue. For the past

15 years, this question has been like the Sword of Damocles hanging over the head of the securitisation of security interests-attached assets. The Civil Code now completely solves the problem by providing that "the accessory rights obtained by the assignee shall not be affected only because the accessory rights are not registered for assignment or are not transferred for possession." Commercial banks will not be required to register for the change of residential house or automobile mortgages when conducting businesses of credit asset securitisation like RMBS and securitisations of automobile mortgage loan beginning from 2021.

## **The Civil Code Recognises the Pledge and Factoring of Future Accounts Receivable**

Before the promulgation of the Civil Code, there has been a heated dispute on whether future income derived from the supply of gas, power, water, heating and other infrastructure can work as the securitised assets. Article 440 of the Civil Code provides that "current and future account receivables" may be pledged, and Article 761 provides that a creditor of account receivables may "assign its current or future account receivables to the factor." From the general understanding of the PRC's legal system, the assets that can be pledged and factored are naturally transferable assets. Therefore, there seems to be no legal dispute on the legality of the transfer of future account receivables. This rule cannot be found in the existing Contract Law or Property Law. If the future revenue generated from the supply of gas, power, water, heating and other infrastructure can be treated as future account receivables and be securitised, the legal risks of such securitisation business could be resolved. However, the term "account receivables" is not defined in the Civil Code, and the securitisation of future account receivables also involves issues of bankruptcy law. Therefore, whether the securitisation of account receivables has a good prospect is yet to be seen.

## **The Pilot Programme of Infrastructure Real Estate Investment Trusts (REITs)**

On 24 April 2020, the CSRC and the NDRC jointly released the Notice of the Work Related to Promoting the Pilot Programme of Infrastructure Real Estate Investment Trusts (REITs). On 6 August 2020, the CSRC issued the Guidelines for Publicly Offered Infrastructure Securities Investment Funds (for Trial Implementation). Since then, the pilot programme of Chinese-style REITs, based on US experiences, has officially started. During the pilot period, REITs are only allowed to purchase infrastructure assets such as toll roads, warehousing and logistics facilities, and data centres, and are not allowed to purchase commercial real estate such as commercial office buildings, shopping malls, apartments or hotels.

Chinese-style REITs take a more sophisticated approach than US REITs. According to the above-mentioned pilot rules, Chi-

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nese-style REITs adopt the product structure of “publicly offered funds plus infrastructure asset-backed securities”. Under this special structure, an institution that has obtained the qualification for public offered fund managers can set up a REIT in the form of a unit trust, with an aim to raise funds from the public. Meanwhile, subsidiaries controlled by the aforementioned public offered fund manager or corporations controlled by the de facto controllers of the public offered fund manager, both with the qualification for issuing exchange asset-backed securities, will issue asset-backed securities to the REIT established by the public offered fund manager. The public offered fund manager then subscribes for all the asset-backed securities with the funds raised by issuing the REIT, after which the issuer of the asset-backed securities will use such subscription proceeds to purchase the entire equities of a company that holds one or more infrastructure assets. After completing the above transactions, the fund manager shall be in charge of the infrastructure projects proactively and allocate 90% of the amount available for distribution held by the REIT each year to investors.

Whether it is for fund managers or regulatory institutions of REITs, dealing with the complexity of Chinese-style REITs is definitely a formidable challenge. Some market participants with important influence have noticed the complex legal situation of the product structure of infrastructure-based REITs, and are calling on the State Council to enact a simplified set of REITs legal rules. Furthermore, they propose that various government authorities related to the regulation of REITs should co-operate to promote the amendment of the legal system in relation to tax, land and the transfer of state-owned assets.

## **The Opening-up of the PRC's Assets Securitisation Market**

The PRC's asset-backed securities market was further opened to international players in 2020. According to public information, Standard & Poor's and Fitch (two of the top three rating agencies worldwide) have started to provide rating services for asset-backed securities in Mainland China through their wholly owned Chinese subsidiaries. According to the market's reaction, these agencies' rating services have begun to cast a positive influence on the sale of asset-backed securities.

**Global Law Office** has more than 500 lawyers practising in the Beijing, Shanghai, Shenzhen and Chengdu offices and is known as one of the leading Chinese law firms, setting the pace as the PRC's most innovative and progressive legal practitioner. Since China's first public offering and listing on the New York Stock Exchange, the firm has assisted numerous companies in gaining finance from the domestic and overseas capital markets. The securitisation team consists of more than 40 partners

who are experienced in handling highly complex, structured transactions, advising underwriters and issuers in both debt and equity capital markets. Areas of expertise include domestic and overseas IPOs; offerings and listings of conventional and structured fixed-income products; post-IPO financings; M&A of listed companies; restructurings and reorganisations of listed companies; and compliance and corporate governance of listed companies.

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