

TAR: PRC 39008

Technical Assistance to the People's Republic of China for Development of Asset-Backed Securities Market and Restructuring of Asset Management Companies

July 2005

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 5 July 2005)

Currency Unit	–	yuan (CNY)
CNY1.00	=	\$0.1208
\$1.00	=	CNY8.2765

ABBREVIATIONS

ABS	–	asset-backed securities
ADB	–	Asian Development Bank
AMC	–	asset management company
BOC	–	Bank of China
CCB	–	China Construction Bank
CDB	–	China Development Bank
CINDA	–	Cinda Asset Management Company
EA	–	executing agency
GDP	–	gross domestic product
IA	–	Implementing agency
MOF	–	Ministry of Finance
NPL	–	nonperforming loan
PBC	–	People's Bank of China
PRC	–	People's Republic of China
QFII	–	qualified foreign institutional investor
SOCB	–	state-owned commercial bank
SOE	–	state-owned enterprise
SPV	–	special purpose vehicle
TA	–	technical assistance

TECHNICAL ASSISTANCE CLASSIFICATION

Targeting Classification	:	General intervention
Sector	:	Financial
Subsector	:	Financial sector development and reforms
Theme	:	Sustainable economic growth
Subtheme	:	Promoting economic efficiency and enabling markets

NOTE

In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. The Government of the People's Republic of China (PRC) requested the Asian Development Bank (ADB), during the 2004 country programming mission, to provide technical assistance (TA) for the Development of Asset-Backed Securities (ABS) for the Cinda Asset Management Company (CINDA). In addition, the Government indicated that the development of the asset-backed securities market is a top priority. The Fact-Finding Mission¹ visited Beijing 18–26 November 2004 and reached an understanding with the Government on the objectives, scope, and implementation arrangements for the TA.² Appendix 1 gives the TA design and monitoring framework.³

II. ISSUES

2. The PRC financial system is dominated by the banking industry. State-owned commercial banks (SOCBs), policy banks, joint stock commercial banks, city commercial banks, and rural commercial banks, on a combined basis, accounted for 82% of the total assets of the financial sector as of end-2003. The remaining 18% of total financial system resources is divided up among credit cooperatives (10%), postal savings institutions (3%), nonbank financial institutions (3%, which consist of trust and investment companies, financing companies, and leasing companies), and foreign-funded financial institutions (2%). The banking industry is controlled by four SOCBs: Industrial and Commercial Bank of China (ICBC), Bank of China (BOC), China Construction Bank (CCB), and Agricultural Bank of China (ABC). Their combined assets as of end-2003 amounted to CNY15.2 trillion and represented roughly 55% of total financial system resources, 67% of total domestic bank assets, and 130% of gross domestic product (GDP). They also accounted for approximately 90% of all loans to state-owned enterprises (SOEs) and 70% of all loans to state-controlled infrastructure projects.

3. Considering the rapid economic transition and growth of real sectors during the past two decades, the financial sector has lagged behind. Financial market risk has become a major concern for the sustained growth of the economy. At the center of the financial sector problem are (i) the high percentage of nonperforming (NPLs) held by SOCBs, their poor corporate governance, weak institutional capabilities, inadequate operational standards, weak capital bases, and low profitability; and (ii) underdeveloped capital markets. To reduce systemic risks in the banking system, the disposition of NPLs and a sensible restructuring of the SOCBs are critical. The Government established in 1999 four asset management companies (AMCs).⁴ The AMCs were not only charged with removing NPLs from the SOCBs, but also given the mandate to prevent future NPLs from accumulating and to find realistic ways to recover cash value from the transferred NPLs. From 1999 to 2004, NPLs totaling CNY1.37 trillion were transferred at face value of the loan principal and interest from the SOCBs to the AMCs, financed by AMC bonds guaranteed by the Ministry of Finance (MOF). By the end of December 2004, the four AMCs had disposed of CNY675 billion of such NPLs, with a cash collection of CNY137 billion. Although the NPL ratio of the SOCBs has declined over the past 3–4 years, it still remains high

¹ The Mission comprised Y. Qian, Principal Financial Economist of the Governance, Finance, and Trade Division of the East and Central Asia Department.

² The TA first appeared in *ADB Business Opportunities* (Internet edition) on 10 January 2005.

³ Given the strategic importance of this TA for ADB and the PRC, three departments within ADB will partner together in working on this TA: (i) the Governance, Finance, and Trade Division of the East and Central Asia Department (ECGF); (ii) the Private Sector Operations Division (PSOP); and, (iii) the Office of the General Counsel (OGC). The joint effort of the three departments will maximize ADB's impact in this important project.

⁴ CINDA was responsible for NPLs from CCB and the China Development Bank (CDB), the Huarong AMC for ICBC, the Orient AMC for BOC, and the Great Wall AMC for ABC.

compared with that of other countries. The NPL ratio of the four SOCBs, based on the loan classification system,⁵ was 22.2% in June 2003.

4. One of the four AMCs is CINDA. When CINDA was established, the Government transferred to it CNY394.6 billion NPLs from CCB and CDB. CINDA has also served as the collection agent for an additional CNY112.8 billion of NPLs for MOF and CCB. Through a public auction in June 2004, CINDA acquired additional NPLs, with an outstanding principal amount of CNY128.9 billion and CNY149.8 billion at 31% of face value from CCB and BOC, respectively. This auction was a major policy breakthrough.⁶ The acquisition was financed through a refinancing loan from the People's Bank of China (PBC, the central bank) of CNY86 billion or \$10 billion.

5. The most recent purchase of NPLs by CINDA requires optimization of CINDA's funding sources and terms to match the timing and deal structure of its NPL workouts. Without adjusting its liabilities, CINDA will experience asset-liability mismatches, including a duration mismatch if it follows a paced disposition schedule,⁷ and a currency mismatch if a portion of the NPLs are sold to foreign investors.⁸ CINDA is considering meeting its funding requirements by securitizing part of its NPL portfolio by issuing (international/domestic) asset-backed securities (ABS). This issuance will also enable CINDA to share the risks of NPL collection with investors.⁹ A securitization process requires a pooling of (financial or tangible) assets. This asset pool will then be sold to a special purpose vehicle (SPV), which will, in turn, sell securities to investors, backed by the asset pool. In CINDA's case, this asset pool will consist of NPLs.

6. The PRC bond market, to date, has exclusively served the public sector (i.e., national treasury, central bank, and state-owned policy banks). The privilege to issue corporate bonds has been only sparingly given to SOEs. Debt instruments include government bonds, financial policy bonds, and central bank bills, accounting for 57.3%, 34.6%, and 5.3%, respectively. Outstanding corporate bonds make up an anemic 2.8%.¹⁰ The PRC's bond market represented about 30% of GDP as of end-2000, one of the lowest ratios among the Asian bond markets. The Asian financial crisis has confirmed the need to develop long-term domestic bond markets.¹¹ The ABS market is a critical feature of a more developed bond/capital market.

7. Securitization, as a financing tool, has enabled banks and corporations in Europe and the United States to take advantage of various financial and structural benefits. In particular, securitization enables the issuer to issue securities with a higher rating (i.e., lower credit risk)

⁵ The loan classification system has risk categories: normal, special attention, substandard, doubtful, and loss. The ratio of 22.2% is very high compared with ratios in other countries with similar NPL classification standards such as United States (1–2%), France (3–4%), Republic of Korea (2–3%), and Japan (6–7%). It is even higher than the peak of NPLs in Korean banks in 1999 (13.6%) after the Asian financial crisis and the peak of NPLs in Japanese banks in FY2001 (8.4%).

⁶ Prior to this auction, commercial banks in the PRC were subject to strict MOF loan write-off rules, and were not allowed to sell loan principals at a discount and write off the losses.

⁷ CINDA is required to repay the PBC loan in 18 months. If CINDA cannot complete NPL disposition in due time, PBC would need to roll over the refinancing package, thereby continuing the implicit subsidy to CINDA.

⁸ Its short-term liabilities (i.e., 18-month PBC refinancing) will not match the long-term assets (i.e., NPLs stay on CINDA's book for longer terms). Foreign currency debt would be needed to hedge the foreign exchange risk.

⁹ This has been done very successfully in the United States, Japan, Italy, Republic of Korea, Thailand, and Mexico. In Italy, ABSs for NPLs comprise 15% of the securitization market. In the Republic of Korea, KAMCO ABSs had about 10% share in 2000. CINDA has explored the ABS concept and recently reached an agreement with Deutsche Bank for NPL securitization of CNY2.55 billion in overseas markets.

¹⁰ According to *Institutional Investors in the People's Republic of China* (Working Paper Draft, ADB 2004), corporate bonds represent 5% or CNY170 billion of the total PRC bond market.

¹¹ Underdeveloped bond markets narrow a country's choice in raising capital, leading to heavy reliance on the banking system. Banks, on the other hand, risk mismatches in their maturity structures if they continue to provide long-term capital given their short-term liabilities. Therefore, domestic bond markets have a crucial role to play, along with domestic equity markets, in financing investments in areas critical to sustained economic growth.

than that which can be obtained through a direct corporate bond issue. Appendix 2 briefly discusses issues related to the ABS market.

8. ABS transactions impact on multiple legal and regulatory disciplines and agencies. It is well established and recognized that mature and well-developed legal and regulatory regimes covering matters ranging from taxation, accounting, and the issuance of securities to sophisticated insolvency regimes are prerequisites for successful securitization transactions. Successfully addressing these issues is particularly challenging where laws and precedents do not offer answers with a degree of certainty as is required by investors and rating agencies. In the PRC, the development of a concrete securitization market has been stymied due to the lack of a legal and regulatory regime that would support complex securitization transactions. Specifically, obstacles to successful ABS issuances include the following:

- (i) **Legal impediments.** The main legal elements required for ABS transactions include (a) the ability to effectuate a true sale (i.e., the transfer of the economic benefits and risks of the assets from the originator to the issuer); (b) preserving the bankruptcy remote status of the entity to whom the assets are transferred (typically an SPV);¹² (c) the avoidance of entity level taxation on the SPV; (d) perfection of the transfer of assets to the SPV; (e) statutory or other protection from the exercise of setoff rights with respect to the account debtor's underlying contract; (f) avoidance of substantive consolidation of the assets and liabilities of the SPV with those of the originator's bankrupt estate; and (g) the ability of the SPV to issue and sell the securities backed by the assets involved in the ABS transaction. The lack of a centralized loan registration system, tax, accounting and related legal and regulatory issues combine to limit the ability of an AMC to effectuate a "true sale" and, consequently, achieve the key ingredient of a successful issuance of ABS.
- (ii) **Lack of coordinated efforts.** Issuance of ABS for NPLs (and other asset classes) will involve many agencies, including planning and fiscal authorities, the central bank, banking and capital market regulators, and lawmakers. Despite the keen interest expressed by individual agencies, there is no effective coordination among policy makers and financial market regulators that would support ABS transactions.
- (iii) **Market intermediary services.** There are no developed professional standards for services required for ABS transactions, such as credit rating, accounting, and legal services. It is essential that the relevant professional standards are enhanced.

9. Despite the impediments to developing a flourishing securitization market in the PRC, there are a number of encouraging factors:

- (i) **Domestic experience.** There have been a number of "quasi securitization" attempts by domestic financial institutions, including the Huarong AMC's "quasi ABS" in 2003 (effected through a trust investment plan for CNY13.3 billion of NPLs), and the Ningbo branch of the Industry and Commercial Bank's mortgage-backed securitization of CNY2.6 billion.

¹² PRC's Company Law requires a minimum capital of CNY30 million for a company limited by shares and CNY60 million for a limited-liability company. A company cannot issue debt instruments for more than 40% of its net assets, and average distributed profits over the past 3 years must be sufficient to meet the debt interest payments. A trust can have no more than 200 investors. These factors all serve to limit the ability of companies to engage in ABS transactions.

- (ii) **Investor interest.** The number of institutional investors in the PRC has increased rapidly in recent years.¹³ They include commercial banks, insurance companies, social security funds, mutual funds, and qualified foreign institutional investors (QFIIs). Investors are keenly interested in fixed-income instruments such as ABS for better portfolio management.

10. To facilitate the development of an ABS market and explore some of the deficiencies in the PRC's legal and regulatory framework that would support securitization activities, the State Council has given PBC the mandate to undertake two asset-backed securitizations on an experimental basis. Under PBC's guidance, CCB and CDB are in the preparatory stages of launching an asset-backed securitization transaction. These pilot studies will be used as a basis for determining the steps that need to be taken to develop an effective and vibrant ABS market in the PRC.¹⁴

11. In addition to the PBC pilot securitization activities, CINDA plans to allocate CNY20 billion from its recent NPL acquisition from BOC in Guangdong Province to form the asset pool for its upcoming ABS issuance. The recovery cash flow from the NPLs will be used to repay the ABS investors in the international and/or domestic capital markets. CINDA has set up a project team to execute the transaction comprising core staff from its Investment Banking Department and Guangdong branch. However CINDA lacks core institutional capacity to structure and engage in the transaction. CINDA must develop strong ABS structuring and NPL servicing capabilities to successfully execute a complicated ABS transaction.

12. CINDA also recognizes the need to fundamentally reorient its business strategy, organization, and operational modalities to meet the challenges of ABS transactions. AMCs, including CINDA, have faced a number of impediments since their establishment:

- (i) **Unclear institutional mandates.** The 10-year life limit originally given to AMCs appears insufficient to resolve NPLs originating from SOEs and, unless SOEs are fundamentally restructured, NPLs will not be resolved successfully. Also, the governance and operational modalities of AMCs have been heavily influenced by the Government, resulting in AMCs lacking proper incentives and prudent management.
- (ii) **Lack of proper legal and regulatory support.** The lack of well-developed legal and regulatory structures, combined with the lack of a multidisciplinary response to AMC operations (that would serve to address specific AMC-related problems in an integrated fashion) serve to impede AMC operations.¹⁵
- (iii) **Inefficient resource allocation and mobilization.** AMCs are 100% owned by MOF, cannot utilize their registered capital, and have not been authorized to mobilize additional funds.¹⁶ Most AMC staff were transferred from corresponding SOCBs, and lack comprehensive financial market skills.

¹³ Estimates were that by the end of 2003, commercial banks in the PRC had CNY18.2 trillion in deposits; insurance companies had CNY912 billion of assets and CNY388 billion of annual prime income. The National Social Security Fund had CNY120 billion in management, and mutual funds (54 close-ended and 56 open-ended) had CNY160 billion in management. Private investment funds had CNY300 billion–800 billion, and qualified foreign institutional investors (QFIIs) had pledged \$1.7 billion.

¹⁴ ADB's assistance has been requested in implementing these pilot transactions through technical assistance and it is expected that the experience and knowledge derived from the CDB and CCB pilot securitization transactions will complement the activities to be undertaken through component 3 of this TA.

¹⁵ Many legal provisions in the Bankruptcy Law, Company Law, Securities Law, Civil Law, Guarantee Law, etc., make AMC operations difficult.

¹⁶ MOF provided AMCs' day-to-day operating budgets, which are subject to strict controls. According to the Statute of the Asset Management Corporations promulgated by the State Council, MOF has provided capital to four AMCs, and is responsible for supervising the AMCs. MOF's main tasks are (i) approving AMCs' organizational setup and

13. ADB supports PRC's financial sector reforms by (i) helping restructure and strengthen the institutional capabilities of state-owned financial institutions; (ii) enhancing governance by strengthening legal, regulatory, and supervisory frameworks; (iii) encouraging financial institutions to adopt sound corporate governance standards in harmony with international best practices; and (iv) developing the private sector by direct intervention in the form of guarantees, and debt and equity investments. ADB provided CINDA with technical assistance in 1999¹⁷ to support its capabilities in institutional establishment and risk management. ADB also provided technical assistance to financial market regulators for streamlining laws and regulations in the banking, securities, and insurance markets; and to law-making bodies in preparation for adopting the Securities Law, Trust Law, and Bankruptcy Law.¹⁸

III. THE TECHNICAL ASSISTANCE

A. Impact and Outcome

14. The advisory TA will, through the actual process of engaging in an ABS transaction, assist in establishing a conducive policy, legal, and regulatory environment for ABS market development by structuring the issuance of international/domestic ABS for CINDA; exploring restructuring strategies for state-owned AMCs by commercializing/incorporating CINDA; and assisting in the process of developing an effective and comprehensive legal, regulatory and policy framework that will support ABS transactions and otherwise establish a vibrant securitization market in the PRC. Broadly, the development of the broader securitization market will aid in the growth and development of the corporate bond market in the PRC.¹⁹

B. Methodology and Key Activities

15. The TA will be implemented through three closely interrelated components as follows:
- (i) assisting CINDA's ABS project team in actually preparing the first international/domestic ABS issuance from the PRC (component 1);
 - (ii) facilitating the restructuring and corporatization of CINDA and, based on the experience, providing proper restructuring recommendations for other AMCs (component 2);²⁰ and

business scope; (ii) approving AMCs' financing; (iii) setting on the supervisory board of each AMC; (iv) formulating regulations on NPL resolution and operation of AMCs; (v) setting up AMCs' operational target on NPL resolution, and carrying out assessment and supervision; (vi) formulating the financial regulation and the accounting regulation of AMCs, and approving major financial affairs; (vii) studying and proposing reform and development schemes for AMCs; and (viii) studying and proposing solutions for AMCs' losses from NPL resolution.

¹⁷ ADB. 1999. *Technical Assistance to the People's Republic of China (PRC) for Institutional Strengthening of the CINDA Asset Management Company*. Manila (TA 3303).

¹⁸ ADB. 1998. *Technical Assistance to the PRC for Legislation Drafting Support for PRC Securities Law*. Manila (TA 3032); ADB. 1998. *Technical Assistance to the PRC for Strengthening the Banking Supervision and Liquidity Risk Management System*. Manila (TA 3098); ADB. 1999. *Technical Assistance to the PRC for Development of Economic Law*. Manila (TA 3279); ADB. 1999. *Technical Assistance to the PRC for Capacity Building for the Insurance Sector Regulatory and Supervision System*. Manila (TA 3302); ADB. 1999. *Technical Assistance to the PRC for Capacity Building of the Capital Markets' Regulatory System*. Manila (TA 3304); ADB. 2002. *Technical Assistance to the PRC for Banking Laws and Regulations*. Manila (TA 3890); ADB. 2003. *Technical Assistance to the PRC for Foreign Bank Rating and Risk Control System*. Manila (TA 4240); ADB. 2004. *Technical Assistance to the PRC for Strengthening of the Statistical System of the China Banking Regulatory Commission*. Manila (TA 4349).

¹⁹ This is further supported by the efforts of ADB's Treasury Department to issue a CNY-denominated bond in 2005.

²⁰ ECGF and PSOD will take the lead in implementing the first two TA components.

- (iii) helping the Government and financial sector regulators streamline the legal, policy, and regulatory environment for domestic/international ABS transactions (component 3).²¹

C. Cost and Financing

16. The total cost of the TA is estimated at \$1,250,000 equivalent, of which \$615,000 is in foreign exchange and \$635,000 equivalent in local currency. The Government has requested ADB to finance \$1,000,000 equivalent, covering the entire foreign exchange cost and \$385,000 equivalent of the local currency cost. The TA will be financed on a grant basis by ADB's TA funding program. The Government, through local agencies, will finance the balance of the local currency cost, equivalent to \$250,000, through the provision of office space, counterpart staff, transportation, and other services. Appendix 3 gives the detailed cost estimates and financing plan.

D. Implementation Arrangements

17. MOF will be the Executing Agency to provide overall leadership and policy coordination among the three TA components. CINDA will be the Implementing Agency (IA) for component 1. MOF and CINDA will be the IAs for component 2. PBC will be the IA for component 3. The TA will engage five international and six domestic consultants for a total of 11 and 19 person-months, respectively. Appendix 4 gives the terms of reference for the consultants. Given the broad range of components to be covered under the TA, each consultant will be selected and engaged on an individual basis in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for selecting and engaging domestic consultants. The TA will begin in August 2005 and will be completed in December 2006. Workshops will be held periodically to invite comments from international and domestic experts, and to disseminate the findings in the reports.

IV. THE PRESIDENT'S DECISION

18. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$1,000,000 on a grant basis to the Government of the People's Republic of China for the Development of Asset-Backed Securities Market and Restructuring of Asset Management Companies and hereby reports this action to the Board.

²¹ OGC will take the lead in implementing this TA component.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
<p>Impacts</p> <p>Improved financial market infrastructure for nonperforming loan (NPL) resolutions</p> <p>Development of the corporate bond and securitization market of the People's Republic of China (PRC).</p>	<p>Implementation of comprehensive strategies for reform of state-owned asset management companies (AMCs)</p> <p>Development of an effective and comprehensive legal, regulatory, and policy framework that will support asset-backed securities (ABS) transactions</p>	<p>Reports by financial market regulators and by industry professionals</p>	<p>Assumption</p> <p>The Government has a strong commitment to financial sector reforms.</p>
<p>Outcomes</p> <p>Proper strategies, legislation, and regulations to address various impediments to AMCs' operations and to ABS market development</p> <p>Implementation plans for actions</p>	<p>Successful closing of CINDA ABS issuance in December 2005, backed by an asset pool of NPLs</p> <p>Corporatization of CINDA before June 2006</p>	<p>Progress reports by consultants and the executing agency (EA) and implementing agencies (IAs)</p> <p>Supervision by review missions</p>	<p>Assumption</p> <p>The Government places high priority on development of the ABS market.</p>
<p>Outputs</p> <ol style="list-style-type: none"> 1. Issuance of the international/domestic ABS for CINDA 2. Development of restructuring strategies for state-owned AMCs 3. Streamlining of the legal, regulatory, and policy framework that will support ABS transactions 	<p>Proper transaction structure and documentation for CINDA ABS issuance before December 2005</p> <p>CINDA adoption of best corporate governance and a new business strategy before June 2006</p>	<p>Progress reports by consultants and the EA and IAs</p> <p>Supervision by review missions</p>	<p>Assumptions</p> <p>Sound recommendations are accepted and implemented.</p> <p>Related government agencies coordinate closely.</p>
<p>Activities and Milestones</p> <ol style="list-style-type: none"> 1.1 Financial and legal due diligence of NPLs, data analysis, and retrieval systems (09/05) 1.2 Design of the overall financial/business/legal structure for an ABS issuance (10/05) 1.3 Design of ABS structure, draft legal documents and ABS prospectus (12/05) 2.1 Recommendations on adequate corporate governance, operational, financial, and risk control mechanisms (03/06) 2.2 Drafting of the legal documents required to effectively corporatize CINDA (06/06) 3.1 Comparative analysis of legal and regulatory issues (12/05) 3.3 Drafting the securitization law (12/06) 			<p>Inputs</p> <p>Implementation of various tasks by international and domestic consultants</p> <p>Training sessions and seminar for CINDA staff and policy makers</p>

DEVELOPMENT OF A BOND AND ASSET-BACKED SECURITIZATION MARKET

1. The Asian financial crisis has confirmed the need to develop further the long-term domestic bond markets in the region. Despite generally high rates of savings, long-term savings have not been efficiently mobilized. Private sector investments in rapidly growing emerging economies have had to be financed with short-term foreign borrowing. To avoid the risk of mismatches, governments in ADB's developing member countries (DMCs) have been looking for ways to address this issue, often combined with measures to address systematic risks caused by the high ratio of nonperforming loans (NPLs) and nonperforming assets (NPAs) in their respective banking systems. This is especially the case in the People's Republic of China (PRC).
2. Underdeveloped bond markets narrow a country's choice in raising capital, leading them to rely heavily on the banking system. Banks, on the other hand, risk mismatches in their maturity structures if they continue to provide long-term capital given their short-term liabilities. For lack of alternative sources of domestic long-term capital, in the past firms often turned to international wholesale credit markets, and thus exposed themselves to exchange-rate risks in the payment of debt. The Asian crisis has worsened those risks and has reduced the flow of portfolio lending to Asian countries. Very little long-term capital is being mobilized in the region. Clearly, domestic bond markets, along with domestic equity markets, have a crucial role to play in financing investments in areas critical to sustained economic growth. Reforms in these markets are thus a key part of financial market reform in Asia in general. A crucial element of a functioning capital market is issuance of asset-backed securities (ABS).
3. Asset-backed securitization is a highly structured financing technique that provides an entity with an economical means of financing without the added burden of increasing debt and/or equity. In its simplest form, securitization is a process whereby the revenue stream on a segregated pool of receivables or other income-producing (mostly financial) assets owned by an original lender or commercial enterprise (originator) is repackaged into tradable securities issued to investors. The receivables are sold by the originator to a specially incorporated, off-balance sheet company or trust, known as a special-purpose vehicle (SPV). In return, the SPV will generally pay a purchase amount equal to the (par or net present) value of the receivables and with limited recourse or no recourse against the originator for nonperformance of the underlying debtors.
4. The SPV will be structured to control its income and expenses so that it will be "bankruptcy remote." The SPV will fund the purchase of the receivables through the issue of debt securities to investors, which will be secured on the receivables by virtue of a security interest granted to a security trustee acting for the investors and other creditors. The originator (or an associated company) may continue to act as the servicer in collecting and administering the receivables as an agent of the SPV, who in turn will apply the income from the receivables to make payment of principal and interest under the debt securities as well as transaction expenses. A standby servicer may also be arranged in case the originator fails to perform its servicing obligations. Funds received by the SPV in excess of those required to pay investors are generally channeled back to the originator. Thus, securitization enables nontradable assets that range in marketability, credit-worthiness, and size to become liquid secondary instruments through repackaging and cash flow structuring.
5. Various forms of credit and liquidity enhancement will be used and structured into the transaction cash flow to ensure that payments on the debt securities issued to the investors are made in full and on a timely basis. Consequently, the recourse of the investors is usually limited to (i) the receivables, (ii) the transaction cash flow, and (iii) the credit enhancement incorporated in the securitization structure. A high credit rating (usually higher than that of the originator) on

the debt securities and therefore cheaper funding can be obtained by reason of the quality of the receivables, the isolation of the receivables from the other risks of the originator's business (by arranging a "true" sale of the receivables from the originator to the SPV), and the arrangements for credit enhancement and liquidity support.

6. Several factors call for the development of a PRC securitization market. (i) The development of the bond and securitization market in particular would reduce the problem of credit tightening as it would release scarce capital of PRC banks, enabling new lending. (ii) Securitization technology could be used to reduce the NPL problem, as new investor bases could be tapped. (iii) Given the increased competitiveness and consolidation process in the financial and corporate sectors, especially after World Trade Organization entrance in 2007, with a fast-changing environment where the mechanics of competition among lenders turn on increasingly tough return on equity (ROE) targets, securitization would allow PRC banks to increase their returns by redeploying the same equity. A bank can make loans at market rates, and then securitize a pool at a lower rate due to diversification and the efficiencies inherent in tranching cash flows. With banks becoming more conscious of the cost of capital and more aware of the need to diversify their sources of funding, securitization of bank portfolios would become a core tool of balance-sheet management. (iv) Securitization would offer PRC banks a new kind of intermediary role by redistributing credit risk in the same way that an insurance provider pools individuals' exposures to loss or accident. In the traditional model, banks did this by matching pools of borrowing with pools of deposits. In securitization, they package credit for capital market investors rather than depositors. To do this effectively, a bank needs a diversified exposure to credit risk—and this is where size wins prizes.

7. Securitization offers an effective means of improving the capital adequacy of the banking and financial sectors, both critical elements in improving the overall performance of the PRC financial sector. The development of the securitization market will aid in the growth and development of the corporate bond market in the PRC in four ways:

- (i) **Credit rating culture.** Based on international past precedents, an independent credit rating system represents a key component in the development of a well-functioning corporate bond market. Only when investors have comfort in an independent rating system will they be able to properly assess the true credit risk in corporate and other bonds.
- (ii) **Credit pricing process.** Securitization issuance will also develop the credit pricing curve. Securitization results directly in the sophistication, consistency, and transparency of the credit pricing process. One of the reasons for the PRC's relatively small (corporate) bond market is the regulatory constraint that interest rates on corporate bonds should not exceed 40% of the equivalent rates of bank deposits.¹ Thus, currently investors may elect not to invest in corporate bonds due to the associated higher risks relative to yield.
- (iii) **Increased Number of institutional investors.** With the growth of the securitization market, more institutional investors will come into the PRC, acting to enhance competition and increase liquidity for the market as a whole.
- (iv) **Diversification for investors.** Securitization issuance and the supply of a wide range of new financial assets will enable institutional investors to better achieve their goals of creating stable, diversified asset portfolios that offer them a better of chance of achieving their return and risk management objectives.

¹ ADB. 2004. Institutional Investors in the People's Republic of China. Draft Working Paper.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank (ADB) Financing^a			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants ^b	440.0	0.0	440.0
ii. Domestic Consultants	0.0	190.0	190.0
b. International and Local Travel	70.0	100.0	100.0
c. Reports and Communications	0.0	20.0	20.0
2. Equipment ^c	20.0	0.0	20.0
3. Training, Seminars, and Conferences			
a. Facilitators (Interpreters and Translators)	0.0	30.0	30.0
b. Domestic Training	0.0	60.0	60.0
4. Miscellaneous Administration and Support Costs	15.0	0.0	15.0
5. Contingencies	70.0	55.0	125.0
Subtotal (A)	615.0	385.0	1,000.0
B. Government Financing			
1. Office Accommodation and Transport	0.0	125.0	125.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	85.0	85.0
3. Contingencies	0.0	40.0	40.0
Subtotal (B)	0.0	250.0	250.0
Total	615.0	635.0	1,250.0

^a Financed by ADB's TA funding program.

^b \$120,000 total (\$40,000 for each component) is earmarked for additional international specialists and will be identified during technical assistance (TA) implementation as the need arises.

^c Equipment to be purchased includes notebook computers, facsimile machines, scanners, data storage devices, and photocopiers. The equipment will be procured in accordance with ADB's *Guidelines for Procurement*, and the equipment will be retained by the implementing agencies.

Source: Asian Development Bank estimates.

COST ESTIMATES AND FINANCING PLAN
(Broken Down by Components)
(\$'000)

Item	Component 1 – ABS Issuance			Component 2 – AMC Restructuring			Component 3 – Legal and Regulatory		
	Foreign Exchange	Local Currency	Total Cost	Foreign Exchange	Local Currency	Total Cost	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing^a									
1. Consultants									
a. Remuneration and Per Diem									
i. International Consultants	180 ^b	0	180 ^b	100 ^c	0	100 ^c	160 ^d	0	160 ^d
ii. Domestic Consultants	0	100	100	0	50	50	0	40	40
b. International and Local Travel	40	10	50	20	10	30	10	10	20
c. Reports and Communications	0	5	5	0	5	5	0	10	10
2. Equipment ^d	10	0	10	5	0	5	5	0	5
3. Training, Seminars, and Conferences				0	0	0			
a. Facilitators (Interpreters and Translators)	0	10	10	0	10	10	0	10	10
b. Domestic Training	0	20	20	0	20	20	0	20	20
4. Miscellaneous Administration and Support Costs	5	0	5	5	0	5	5	0	5
5. Contingencies	40	30	70	10	15	25	20	10	30
Subtotal (A)	275	175	450	140	110	250	200	100	300
B. Government Financing									
1. Office Accommodation and Transport	0	50	50	0	35	35	0	40	40
2. Remuneration and Per Diem of Counterpart Staff	0	40	40	0	20	20	0	25	25
3. Contingencies	0	20	20	0	10	10	0	10	10
Subtotal (B)	0	110	110	0	65	65	0	75	75
Total	275	285	560	140	175	315	200	175	375

^a Financed by the Asian Development Bank's (ADB) TA funding program.

^b \$40,000 is earmarked for additional international specialists and will be identified during technical assistance (TA) implementation as the need arises.

^c \$40,000 is earmarked for additional international specialists and will be identified during TA implementation as the need arises.

^d \$40,000 is earmarked for additional international specialists and will be identified during TA implementation as the need arises.

^e Equipment to be purchased includes notebook computers, facsimile machines, scanners, data storage devices, and photocopiers, and will be retained by implementing agencies.

Source: ADB estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. The technical assistance (TA) consists of three interrelated components, each to be implemented according to the requirements specific to each such component. To ensure that the TA components are implemented in a coherent and coordinated manner, the international asset-backed securities specialist, acting as the team leader for Component 1, will also be the overall team leader and, as such, be responsible for providing overall project implementation guidance and coordination linkage to teams for three respective components, and ensure consistent quality of project management by individual team leaders. The TA calls for 11 person-months of international consultants and 19 person-months of domestic consultants. The domestic consultants will assist the international consultants.

2. The international consultants will be primarily responsible for (i) introducing international experience and best practices in the formulation and issuance of asset-backed securities (ABS), advising the Cinda Asset Management Company (CINDA) project team and disseminating lessons learned (component 1); (ii) assisting CINDA with its institutional restructuring (component 2); and (iii) based on the experience gained through CINDA's ABS issuance, as well as the study and experience gained through the pilot ABS transactions to be undertaken by the China Development Bank and China Construction Bank, providing recommendations to policy makers and legal and regulatory agencies regarding initiatives that need to be undertaken to support the development of an ABS market and supporting legal framework; drafting interim implementing and related regulations required to facilitate the ABS issuances; and, as appropriate, developing laws and related regulations required to support ABS issuances (component 3). Domestic consultants will be required to possess extensive in-depth country and sector knowledge and good contacts with the relevant Government and financial institutions. The domestic consultants will help the international consultants quickly become familiar with their tasks by translating documents into English; researching and compiling relevant government policies, regulations, and procedures; and ensuring that the international consultants' recommendations are appropriately considered and conveyed to the relevant agencies.

3. The consulting team will strictly follow information disclosure requirements of financial market regulators and those of the Asian Development Bank (ADB) for disseminating the TA experience, and will respect the confidentiality requirements of CINDA and other financial service intermediaries involved in the TA.

A. ABS Issuance Team (Component 1)

1. Team Leader and International Asset-Backed Securities Specialist (3 person-months)

4. In addition to acting as the overall team leader, and the team leader for component 1, the specialist will be responsible for delivering timely interim and final reports, identifying and managing resource persons for various technical tasks, and organizing workshops and training activities. The specialist will take the lead in formulating and implementing appropriate strategies that will lead to a successful ABS issuance. The specialist must possess sufficient professional experience in financial markets, specifically in ABS development, in countries whose financial sectors are at a stage similar to that of the People's Republic of China (PRC). Specifically, the specialist will, during the process of engaging in the ABS issuance,

- (i) provide overall leadership in designing and executing the ABS transaction through the following activities:
 - (a) formulating asset pool identification and structuring criteria;

- (b) preparing a financial model for the ABS issuance, recommending appropriate discount rate, discussing and developing underwriting process, and design resolution strategy;
 - (c) designing the overall financial/business/legal structure for an ABS issuance, together with the detailed implementation framework for such an issuance;
 - (d) performing due diligence on, and evaluating the asset pool in conjunction with the nonperforming loan (NPL) appraisal legal specialist and an asset appraiser;
 - (e) analyzing investor demand and identifying indicative pricing ranges;
 - (f) assisting in preparing documentation required for the ABS issuance;
 - (g) formulating an ABS distribution and trading strategy;
 - (h) helping CINDA coordinate with credit rating agencies to obtain a credit rating for the ABS;
 - (i) providing recommendations for an appropriate credit rating for the ABS, based on due diligence outcomes; and
 - (j) preparing summary reports on lessons learned;
- (ii) assist government and financial sector regulators in identifying and, as appropriate, addressing the relevant policy, legal, and regulatory impediments to the development of a successful ABS market in the PRC by
- (a) identifying key successful factors in the transaction structure of ABS issuances in countries with mature ABS markets, preparing case studies that highlight the specifics of these factors, and organizing training activities to disseminate such information;
 - (b) on a comparative basis, assisting the international securitization law specialist in identifying and summarizing the related policy and regulatory areas (e.g., taxation, accounting, credit rating and credit enhancement, and capital markets) that require revision to support the development of an ABS market in the PRC;
 - (c) recommending necessary steps for CINDA to undertake the issuance of ABSs;
 - (d) recommending measures for tax neutrality and proper accounting treatment for securitization transactions; and
 - (e) recommending mechanisms for better policy support and interagency coordination for ABS development;
- (iii) provide advisory guidance regarding ABS execution for management and staff of CINDA and its team of lawyers, auditors, asset appraisers, credit rating agencies, trustees, and central depository staff; and
- (iv) help identify the best strategies for distribution of ABS, either on the interbank bond market or on the stock exchanges, taking into account accession to institutional investors and the corporate bond quota system.

2. International Transactional Legal Specialist (2 person-months)

5. In consultation with the ABS specialist, the international transactional legal specialist will provide legal and regulatory advisory services to CINDA as required to execute the ABS issuance in the current legal and regulatory framework. The international transactional legal specialist will have a minimum of 10 years of experience in ABS transactions and will also possess sufficient experience in legal and regulatory issues of the PRC financial markets, and

sufficient exposure to ABS markets in developed countries. Specifically, the international legal specialist will

- (i) introduce international best practices in the legal documentation required for ABS transactions and organize training sessions to introduce such best practices to CINDA (through detailed case studies and otherwise);
- (ii) design ABS structure, draft legal documents and ABS prospectus, and assist CINDA in the negotiation; and
- (iii) in consideration of the existing impediments to ABS issuances, recommend strategies to properly deal with existing legislation and regulations to facilitate CINDA's ABS issuance.

3. Domestic Nonperforming Loan Appraisal Legal Specialist (7 person-months)

6. The NPL appraisal specialist will help the team leader/ABS specialist manage overall TA implementation, deliver timely interim and final reports, and recruit and manage resource persons in the performance of their specified tasks. The NPL appraisal specialist will also work with and support the activities of the international transactional legal specialist as well as have primary responsibility for supporting the NPL appraisal process. The NPL appraisal specialist will

- (i) examine the appropriateness of the loan documentation for each NPL in the proposed asset pool, and prepare legal due diligence reports for each loan;
- (ii) collect and maintain statistics on the enforceability and status of loan documentation for those loans in the asset pool, and prepare legal due diligence reports for the entire asset pool;
- (iii) examine, through loan documentation, the validity of CINDA's rights to and quality of the underlining collateral and guarantees; assess any legal deficiencies in the underlying loan documentation, recommend remedies for resolving such deficiencies, and determine the effect any such remedies might have on the overall resolution of the NPLs in the asset pool;
- (iv) recommend steps to streamline any potential litigation that may arise, based on the sample of NPLs; and
- (v) prepare reports to summarize lessons learned.

4. Domestic ABS Transaction Legal Specialist (1 person-month)

7. To support the international transactional legal specialist, the domestic ABS transaction legal specialist will

- (i) assist in designing the ABS legal structure;
- (ii) assist in drafting legal documents for the ABS issuance;
- (iii) assist in preparing the ABS issuance prospectus;
- (iv) draft proposals and prepare briefing notes for discussions with financial market supervisors for project approach and regulatory compliance; and
- (v) prepare reports to summarize lessons learned.

5. Domestic Accounting Specialist (2 person-months)

8. The accounting specialist will

- (i) establish a standard electronic database covering the asset pool and loan files and ensure complete consistency of information between paper files and electronic files;
- (ii) fill in information gaps while establishing the electronic files;
- (iii) together with the team leader, produce summary tables for the asset pool;

- (iv) together with the team leader, produce investigative reports (covering inter alia, date of inception, amount, term, secured or unsecured, etc.) for each debtor in the sample asset pool;
- (v) help the team leader with activities related to credit rating;
- (vi) help provide information during preparation of the ABS issuance prospectus, including drafting of comfort letters;
- (vii) advise on accounting and taxation issues pertaining to the proposed ABS structure and help CINDA coordinate with accounting standard setting and tax authorities, including drafting of accounting and taxation position papers; and
- (viii) prepare summary reports of lessons learned.

9. The consultants will submit (i) inception reports 2 weeks after the start of their services; (ii) interim progress reports at appropriate stages of TA implementation; (iii) draft final reports before the conclusion of the contract; and (iv) final reports 2 weeks after incorporating the EA's and ADB's comments. All reports must be submitted in both English and Chinese.

B. Commercialization/Incorporation Team (Component 2)

1. Team Leader and International Institutional Restructuring Specialist (1 person-month)

10. As team leader for component 2, the international institutional restructuring specialist, under the overall guidance and the coordination of the overall team leader, will be responsible for managing the implementation of component 2, delivering timely interim and final reports, identifying and managing resource persons for various technical tasks, and organizing workshops and training activities. In consultation with the other specialists, the international institutional restructuring specialist will examine the relevant commercial policy and institutional issues that may have an adverse impact on the ability of CINDA to appropriately corporatize its operations, and recommend and assist in implementing suitable strategies for the institutional restructuring of CINDA. The specialist should have sufficient experience with restructuring of financial institutions in countries at development stage similar to that of the PRC. Specifically, the specialist will

- (i) identify institutional, financial, and operational risks for CINDA based on commercial principles;
- (ii) assist in the development of a restructuring plan and a strategy for CINDA to corporatize, based on sound operational, financial, and risk mitigation considerations;
- (iii) recommend feasible solutions on funding losses incurred from NPL workouts;
- (iv) recommend adequate operational, financial, and risk control mechanisms;
- (v) assess existing corporate governance, and recommend measures to improve corporate governance practices for CINDA;
- (vi) develop a business development strategy, prepare business plans;
- (vii) design tool kits for NPL appraisal, NPL workouts, and risk management based on commercial principles;
- (viii) develop and implement a comprehensive training program in corporate governance, and CINDA's new business strategy;
- (ix) evaluate and recommend improvement for accounting and internal control systems for recording and reporting financial transactions to ensure staff incentive schemes and impacts on the cost-effectiveness of operations and overall financial results, and on staff morale and motivation; and

- (x) estimate potential external funding needs and plans, including future ABS and other fund raising to support the resolution of NPLs and development of new resolution techniques, including
 - (a) preparing financial analysis data to provide quantitative and qualitative examinations to assess viability and the adequacy of the funding plan, and advise on the application of conditions, or covenants, that should be required as conditions; and
 - (b) forecasting for a period covering the duration of the funding program, at least to the end of the fifth year.

2. Domestic Institutional Restructuring Specialist (4 person-months)

10. The domestic institutional restructuring specialist will work with the international institutional restructuring specialist to

- (i) review policy and institutional impediments to CINDA's commercial operations;
- (ii) discuss with the Ministry of Finance (MOF), identify a strategy to close the book for policy-based operations for CINDA, and recommend feasible solutions on funding losses incurred from NPL workouts;
- (iii) help develop the restructuring plan for CINDA;
- (iv) identify corporate governance issues and introduce transparent corporate governance practices;
- (v) prepare business plans, and draft proposals for restructuring;
- (vi) institute prudent risk-management practices;
- (vii) develop new human resource guidelines, based on a proper incentive structure; and
- (viii) develop and implement a comprehensive training program.

3. International Corporate Law Specialist (1 person-month)

11. The international corporate law specialist will

- (i) identify proper ownership, capital structure, and management structures for the corporatization of CINDA;
- (ii) ensure better corporate governance practices through adoption of proper legal documents for incorporation, such as Articles of Association and Shareholders' Agreements etc.;
- (iii) draft the legal documents required to effectively corporatize CINDA;
- (iv) draft proposals to regulators for restructuring and corporatizing CINDA; and
- (v) file required applications and assist CINDA in its discussions with relevant government and financial market regulators.

4. Domestic Corporate Law Specialist (1 person-month)

12. The domestic corporate law specialist will assist the international corporate law specialist in performing his/her duties. Specifically, the domestic corporate law specialist will conduct research on and compile the set of Government policies, regulations, and procedures applicable to CINDA's corporatization, and ensure that the recommendations of and documentation prepared by the international corporate law specialist are appropriately considered and are consistent with applicable local laws.

13. The consultants will submit (i) inception reports 2 weeks after the start of their services; (ii) interim progress reports at appropriate stages of TA implementation; (iii) draft final reports before the conclusion of the contract; and (iv) final reports 2 weeks after incorporating the EA's and ADB's comments. All reports must be submitted in both English and Chinese.

C. Legal and Regulatory Team (Component 3)

1. Team Leader and International Securitization Law Specialist (4 person-months)

14. As team leader for component 3, the international securitization law specialist, under the overall guidance and the coordination of the overall team leader, will be responsible for managing the implementation of the TA component, delivering timely interim and final reports, identifying and managing resource persons for various technical tasks, and organizing workshops and training activities. The specialist will support and facilitate the development of a legal and regulatory framework that will nurture and sustain the development of a comprehensive, integrated, and sophisticated market for ABS issuances in the PRC; will track the progress of CINDA's ABS issuance to identify and isolate issues requiring both immediate and long-term solutions that arise in the context of ABS issuances; and will consider the experience of other domestic ABS issuers in the PRC by identifying and analyzing such issues. Subsequent to identifying such issues, the specialist will work with the relevant Governmental legal and regulatory agencies to craft and implement immediate and long-term responses to facilitate CINDA's ABS issuance as well as recommend long-term solutions to future ABS issuances.

15. The international securitization law specialist will have a minimum of 10 years experience in ABS transactions in developed markets as well as significant exposure to and familiarity with the PRC legal and regulatory framework. The specialist should also have experience in drafting and formulating laws and regulations. Specifically, the specialist will

- (i) assist the People's Bank of China (PBC) with its ongoing review and study of the legal impediments to engaging in effective ABS securitization transactions in the PRC, and advise on specific actions required to overcome such impediments. Such advice will, as appropriate, include a comparative analysis of how similar legal issues are treated in other jurisdictions;
- (ii) assist PBC in identifying and implementing immediate solutions to existing impediments to ABS transactions that are effective within the existing legal framework; such assistance may take the form of preparing interim regulations or other similar rules as appropriate;
- (iii) based on the practical experience of CINDA, China Development Bank, and China Construction Bank gained through their respective ABS issuances, provide recommendations for eliminating the existing legal hurdles as required to support a comprehensive, integrated and effective legal framework for ABS transactions;
- (iv) assist in interpreting existing laws (i.e., the Trust Law, Company Law, etc.) to determine whether such laws support ABS transactions and what changes may be required to incorporate ABS supportive components into such laws (e.g., supporting the establishment of special purpose vehicles (SPVs)); prepare interim regulations to assist in these efforts on an as-required basis;
- (v) if deemed appropriate, assist in drafting a new comprehensive securitization law that will support the ABS market and provide relevant judiciary training; and
- (vi) organize activities designed to share the PRC experience with securitization law authorities of other nations as well as undertake, as required, a comparative study of international practices in implementing laws that support securitization transactions.

16. The international securitization law specialist will report to both the team leader and ADB, and will coordinate closely with the domestic securitization law specialist and resource persons.

2. Domestic Securitization Law Specialist and Resource Persons (4 person-months)

17. The domestic securitization law specialist will assist the international securitization law specialist in performing his/her duties. Specifically, the domestic securitization law specialist will conduct research and compile the relevant Government policies, regulations, and procedures necessary to support the international securitization law specialist's TA activities, assist in preparing any interim regulations or similar rules, and assist in organizing and presenting seminars and training. The domestic securitization law specialist will coordinate with the relevant PRC Government agencies and ensure that the international securitization law specialist's recommendations are appropriately considered by such authorities and are consistent with applicable local laws. The domestic securitization law specialist will report to the international securitization law specialist and to the team leader.

18. The international securitization law specialist will be responsible for submitting to the team leader, ADB, and PBC (i) an indicative outline of the specific issues encountered that impede a successful ABS transaction (2 weeks after commencing services); (ii) interim reports on the progress of the TA (the timing of such reports to be determined during TA implementation); (iii) copies of any draft interim regulators, rules, or laws proposed to support ABS issuances; (iv) comprehensive plan for addressing the broader implications of adopting such regulations and/or laws; (v) draft final report 2 weeks before the conclusion of the contract; and (vi) a final report within 15 days of receiving ADB's and PBC's comments on the draft report.