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The Use of Securitization to Fund Social Assets in the People’s Republic of China

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For Asian Development Bank

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ABBREVIATIONS

ADB - Asian Development Bank
CMHC - Canada Mortgage and Housing Corporation
CNY - Chinese Yuan
CRE - commercial real estate
GSE - government sponsored enterprise
LGFV - local government financing vehicle
PRC - People’s Republic of China
SPV - special purpose vehicle

CURRENCY EQUIVALENTS
(as of 7 March 2017)

Currency unit – yuan (CNY)
CNY1.00 = $0.1449
$1.00 = CNY6.9036
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EXECUTIVE SUMMARY

- Ongoing reforms of local government financing in the People’s Republic of China (PRC) could involve the securitization of infrastructure assets, in particular commercial property, which has already proved successful in developing and developed economies around the world. The PRC is already the largest market for securitization of financial assets in Asia but securitization of commercial property including social assets lags behind. Social assets includes affordable housing for rent, educational and health facilities, commercial real estate used for social services and environmental protection, and physical infrastructure such as roads, local railways, bridges, port facilities, and airports.

- Securitization of social assets could be another option for "front-door" financing infrastructure at the local level of government. As such, it is complementary to using public-private partnerships for that purpose. It could also help local governments to mobilize resources for debt repayments. A government-sponsored securitization market for local government commercial assets has the potential to be very large, liquid, and sustainable across the economic cycle, and securitized social assets could be an important part of it.

- In other countries, securitization of commercial real estate (CRE) assets, including offices, retail premises and social housing typically encompasses (i) a revenue stream sufficient to maintain interest payments and cover third-party costs and (ii) security over a physical building or buildings so that funds can be realized in the event of a default. In the PRC a potential mechanism to create a revenue stream for social CRE assets is for a local government to sell them to and lease them back from a special purpose vehicle.

- However, this sale and leaseback does not address the refinancing risk at maturity nor the concentration risk deriving from the fact that the securitization income comes from local government entities rather than a mix of commercial enterprises. Some form of government support might thus be needed to overcome these two risks.

- Several countries have created government-supported enterprises (GSE) for that purpose and succeeded in creating large and liquid CRE securitization markets. In the PRC such a GSE would be an alternative to central or provincial level borrowing for municipal investment projects. Where guarantees are needed, a GSE could help to transform implicit guarantees into explicit ones and at the same time effectively control the amount of borrowing of local governments for specific social assets.
I. INTRODUCTION

1. In the past, local government financing vehicles (LGFV) were widely used in the PRC to fund local infrastructure. While they have served a purpose, they have also left a legacy of problems. Apart from maturity mismatches and the loss of financial discipline and transparency associated with off-budget borrowing, regional and local government debt, including contingent liabilities, has increased rapidly in the last few years. The use of LGFVs has thus been prohibited by the government as part of a broader initiative to put local government and infrastructure financing on a sounder footing. Ongoing reforms of local government financing aim to “open the front door and close the back door.” This means allowing local governments to borrow directly to finance deficits and preventing their borrowing off-budget through LGFV, while bringing all legitimate fiscal activities on-budget. While the “back door” is being closed, the “front door” is carefully being opened with borrowing volumes centrally controlled and borrowing powers still limited to provincial level governments.

2. Meantime, the PRC has become the largest market in Asia for securitization of financial assets (such as SME and car loans). On this basis, a market for securitized social assets could be developed to become part of “front door” financing of local governments, as this type of securitization is a well-established financing technique across developed economies and also in a substantial number of developing economies. It helps to mobilize capital market funding, primarily by long-term institutional investors, for the provision of infrastructure and social services. The most frequently securitized physical asset class worldwide is residential mortgages. The next largest asset class is financial receivables arising from commercial property, including social housing.

3. The securitization of infrastructure assets would be complementary to the ongoing development of public-private partnerships (PPP) for the provision of infrastructure and social services. PPP is designed for large new infrastructure projects where the private sector can play a greater role than just providing finance. Securitization also has the potential to enhance the financing available to some of these PPP projects. But securitization can also be used to finance those projects, for which public sector procurement remains the most efficient delivery option or where the size of the project does not justify the overhead cost of PPP. Finally, the outstanding balance of existing infrastructure originally funded by LGFV is very large but does not qualify for PPPs. However, these assets can potentially be securitized.

II. ISSUES

4. Securitization of CRE assets has two main elements: (i) a revenue stream which is expected to be sufficient to maintain interest payments and cover third-party costs of the securitization and (ii) security over a physical building or portfolio of buildings so that the agent or trustee can enforce that security in the event of default of the securitization and realize sufficient funds to repay at least the senior investors. Where such security cannot be given or where the security available does not meet rating agency requirements, an alternative mechanism needs to be developed. This seems to be the case in the PRC.

5. In considering the securitization of CRE assets, it is important to bear in mind the efficiency of the transaction relative to alternative methods of financing. The key considerations are how much money can be raised in relation to a particular building or portfolio of buildings (both in absolute terms and relative to alternative forms of finance),
the cost of the debt (again both in absolute and relative terms), and the term of available securitization funding.

6. Ratings are an essential element of securitization. Each agency has a global approach to rating CRE securitizations. This approach is then modified to cater for specific country issues and/or the particular structure of the transaction. Local factors may include a lack of liquidity in the CRE market, a lack of a central land registry, an inability to take on registered security over a CRE asset and/or uncertainty over legal issues, in particular the insolvency regime or consistency in court interpretation of the laws of property or contract. The enabling environment of the PRC in these areas is still not as developed as in mature market economies.

7. Potential structures of CRE asset securitization in the PRC need to be efficient, replicable and sustainable. Some local government-owned assets are effectively leased to third parties and some of them produce sufficient commercial income to support securitization. Many other CRE assets have little or no income derived from third parties. An example would be certain social assets owned and operated by the relevant local government entity.

8. A potential mechanism to create a revenue stream for social CRE assets that might enable them to be efficiently securitized is “sale and leaseback”—sale by a local government to a special purpose vehicle (or a state-owned enterprise) and leaseback from the vehicle to the local government. Whilst the sale and leaseback structure is part of the answer, it is insufficient on its own to achieve high investment grade securitizations or to achieve a large, liquid and homogeneous securitization market for local governments’ social CRE.

9. Individual sale and leaseback transactions by local governments will need to be aggregated with many other sale and leaseback transactions across multiple local governments to begin to diversify the credit risk of a single local government and to create large efficient securitizations. Such aggregated securitization transactions, as well as being large and diverse, will need to share common structures and documentation in order to create a homogenous market for such social CRE securitizations. Large aggregated transactions will achieve higher ratings than smaller securitization transactions featuring a single local government entity.

10. The rating of many local governments is relatively weak and local governments are strongly correlated from a credit perspective. Some form of additional support (probably at provincial or central government level) will be required to achieve high investment grade ratings even for aggregated transactions.

III. INTERNATIONAL BEST PRACTICE

11. Six key characteristics that are found in the majority of international securitization transactions:

(i) Legal separation of the physical asset into a special purpose company.
(ii) Tranching of debt at different rating levels to maximize the amount raised.
(iii) Provision of credit enhancements. Typically, portfolios of, for example, consumer assets, when rated as a stand-alone portfolio, are assigned a BBB− (investment grade) or BB+ (high speculative grade) rating. When such portfolios are structured into securitizations, 80–90% of the value of the
portfolio at the senior debt level is rated AAA. The difference can be explained by the provision of credit enhancements within the structure. Tranching alone would not be sufficient to create a senior tranche that accounts for more than a small percentage of the total. The raw portfolio may be subject to severely reduced collections for short periods of time due to adverse economic conditions, for instance, and may suffer losses through mismatch between fixed and floating interest rates, uninsured property losses, higher credit losses than expected, or through un-hedged cross-currency exposures. Such mismatches or unexpected events can be mitigated by adding a number of individual credit enhancements. Many of these are usually provided by highly rated counterparts.

(iv) Comprehensive legal documentation as securitizations are generally considered to be the most complex debt instrument in global capital markets. Securitizations are highly rated on the basis that the behavior of the structure, the servicer, and investors are tightly controlled by the legal documentation.

(v) Investment grade credit ratings. Many investors do not have the time or necessary skill and experience to fully analyze the structure of a transaction. In all markets, we therefore see at least one but usually two credit rating agencies rating each class of note that is intended to be distributed.

(vi) Arranging and distribution by investment banks.

12. Social assets have been securitized in a number of industrialized countries and include affordable housing for rent (social housing), educational and health facilities, CRE used for social services and environmental protection, as well as physical infrastructure such as roads, local railways, bridges, port facilities, and airports.

13. There are a number of challenges in the PRC legal system and culture which make it difficult to replicate the securitization structures used in Europe and much of Asia. These include the inability and/or unwillingness of local government entities to give effective security over their social infrastructure assets. North America used fully structured securitizations which are broadly similar to European structures and also has a very large market which features AAA guarantees of principal and interest granted by government sponsored enterprises (GSEs). The use of GSE guarantees in the PRC would overcome the barriers that would prevent PRC securitizations using European-type structures.

14. Securitization markets for affordable housing are very large and liquid in Canada and also the United States of America. Three major GSEs were instrumental in creating these markets by supporting the securitization of affordable housing (both for ownership and rental). These GSEs provide credit enhancement and also play a major role in controlling credit standards, origination and the subsequent securitization of affordable housing assets. The same structure is used for other social assets, particularly in Canada.

15. In the United States, the two most prominent GSEs are Fannie Mae and Freddie Mac and in Canada the Canada Mortgage and Housing Corporation (CMHC). The main difference between them is that CMHC is a government entity and its guarantees carry the full faith and credit of the Government of Canada, whereas Freddie Mac and Fannie Mae are government supported and, through preference shares, government controlled but their guarantees are not legal obligations of the Government of the United States. Both rating agencies and investors consider there to be an implicit central government guarantee and both US GSEs are rated AAA. The GSEs charge a premium for their
guarantees and are therefore potentially self-financing, as in the Canadian example where losses have never exceeded premium income.

IV. POLICY RECOMMENDATIONS

16. The development of a large liquid and highly rated local government infrastructure securitization market would not only help to provide infrastructure and social services in an efficient and transparent manner but would also assist in the further development and diversification of the PRC capital market. The majority of LGFV’s were funded by bank loans whereas the propose type of securitization takes the form of tradable securities, which issuance is cheaper than that of bonds issued to finance individual PPP projects.

17. The refinancing of outstanding LGFV’s and the funding of new infrastructure which fall outside the PPP framework is a market of at least the size of the current PRC government bond market. A government-sponsored securitization market has thus the potential to be very large, liquid, and sustainable across the economic cycle. While most investment is likely to be by domestic investors, a sub-instrument might be developed for international investors only.

18. To create this market, the government might want to consider the following recommendations:

- Establish a uniform national system to support the securitization of social assets provided at the local level of government through sale-leaseback transactions. Uniform documentation of the underlying leases across all projects reduces both legal costs and time to design each transaction.
- Aggregate portfolios of leases to create large liquid transactions. The aggregation of many individual leases into large portfolios allows for large and efficient financings.
- Create a government level guarantee organization or use an existing one to facilitate securitization of social infrastructure assets. A central organization is needed to control how local governments use and have access to the securitization program. Such an organization also controls the aggregation of many underlying leases into large securitization portfolios and controls the issuing volume to the securities market.
- Provide a governmental level guarantee to each portfolio transaction. In providing such a guarantee (which may be direct or indirect) the cost of funding to be passed through to individual local authorities is minimized. Such a guarantee should deliver credible AAA ratings thereby maximizing the investor base. An explicit guarantee would be more transparent and targeted than the implicit guarantees local governments and most state-owned enterprises still enjoy.
- To tap the widest investor interest, the central organization should issue across a broad range of maturities with shorter dated issues aimed at banks and longer maturities aimed at pension and insurance companies and investment funds, which need longer-term high quality investment.
19. The proposed mechanism for securitizing social assets can be summarized as follows:

- Local governments sell individual social assets to a special purpose vehicle (SPV), which might be a local SOE or the central guarantee organization, and then lease them back. If the lease is with the central guarantee organization it is already in the right place. If the lease is with a local SPV/SOE then it is purchased at par by the central guarantee organization.

- Under this arrangement the SPV receives a stream of lease payments over the period of the lease, with the local government undertaking to “buy-back” the social asset at the end of the lease. The lease can also be rolled over by mutual agreement on terms to be agreed at the time of the rollover.

- The central guarantee organization aggregates large diverse portfolios of leases representing 100 or more individual local authorities and then issues standardized securities to market investors at a size and maturity that suits the market. These securities carry a central government-level guarantee (either direct or indirect) and so have a local AAA rating. The guarantee organization is self financing as it charges a premium for its guarantee; the lease payment is the sum of the debt cost plus the guarantee cost.

- Securitized securities are thus issued from time to time by the central guarantee organization. Each issue is collateralized by a portfolio of lease rental obligations underpinned by certain social infrastructure assets leased to multiple local government entities. The issuance is further supported by a principal and interest guarantee from the central guarantee organization. By virtue of both the collateral and the guarantee the securities are expected to be rated AAA by rating agencies. The securities issued from time to time will be of various durations to suit market conditions and investor preferences.

20. The benefits of the proposal can be summarized as follows:

- The cost of debt issuance is reduced by securitizing large and diversified revenues streams associated with certain physical assets; by using standardized legal documentation, both at the level of the lease and also at the level of debt issuance; and by a guarantee that is, directly or indirectly, in any case needed to tap private sector funding for social assets.

- Local governments thus gain access to cheaper funding for social assets than they previously had access to through LGFVs or via issuing local government bonds directly to the market. They also have a more stable source of funding for such assets over the business cycle, as the proposed mechanism is less prone to “freezing” when market conditions deteriorate.

- The central government has a controlled vehicle for guaranteeing local government financing, which can be seen as an additional “front door” for financing local government social infrastructure. This will enable the current “back doors” for financing to be closed more efficiently. Both the amount of debt that individual local government carry and the use of funds raised are controlled.

- Creating a large new class of financial assets will help deepen PRC capital markets.