

Research in the Securitization of the Non-performing Loans of China's State-owned Banks

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Abstract: In this paper, through analyzing the necessity of the securitization of the non-performing loans of China's state-owned banks, the author proposes some tentative ideas for the securitization of the non-performing loans and works out some problems that need to be solved in this process.

Key words: securitization non-performing loans

1. Current Market Status of the Securitization of Non-performing Loans

Securitization of non-performing loans is a special form of asset securitization and is the securitization of the non-performing loans that have had or are likely to have problems with their liquidity and earnings. In relation to the securitization of high-quality assets, the securitization of non-performing loans is designed to efficiently use the stock of bad assets and increase the value of settled capital, not merely to increase their liquidity. Investors relating to the securitization of non-performing loans are more radical in terms of risk preference and aim for the high investment returns.

Thanks to the rapid development of asset securitization, the market scale of the securitization of non-performing loans has also maintained the momentum of fast development. Generally speaking, the main component of the securitization of non-performing loans is the securitization of the non-performing loans of commercial banks.

Resolution Trust Corporation (RTC) was the first to dispose their non-performing loans by securitizing them. In order to dispose the non-performing loans of S&L, RTC was established in 1989^[1]. It began its business with the transaction of securitized assets that worthy \$50 million in 1991. By 1994, RTC had completed the transaction of securitized assets that worth \$43 billion.

Following the Asian financial crisis, asset securitization was more widely used to dispose the non-performing loans of banks. The Sanwa Bank of Japan issued European yen bonds worth \$300 million in support of inactive loans. By 2000, Korea Asset Management Corporation (KAMCO) disposed non-performing loans through securitization accounted for one-third of all such loans it had disposed of, and the recovery rate was high. KAMCO issued non-performing loan securities worth \$367 million in 2001.

According to the international experience, whether an asset is good has nothing to do with whether or not it can be securitized, but depends on whether there is an interest balance between issuers and investors. People invest in asset-backed securities not because they want to possess non-performing loans but to obtain investment returns. Whether non-performing loans can be securitized depends on whether issuers are satisfied with the recovery rate of the securitized non-performing loans, on whether there are proper channels for investing the proceeds from securities issues, and on whether investors are satisfied with the risk and earnings of securitizing

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non-performing loans. Non-performing loans can be securitized as long as issuers set prices in accordance with the market principle and investors invest in accordance with the return ratios and risks formed in the market.

China has basically done nothing about securitization of non-performing loans, but its relevant asset management companies have worked with their foreign counterparts on projects to securitize the non-performing loans. But so far, there have been no substantive results.

2. The Necessity to Securitise the Non-performing Loans of China's State-owned Commercial Banks

2.1 Securitizing Non-performing Loans Is an Important and Effective Way to Guarantee and Promote the Attainment of the Objectives of Disposing the Non-performing Loans of the State-owned Commercial Banks

After China joined the WTO, the country's state-owned commercial banks have worked out detailed plans for controlling and reducing non-performing loans in order to establish a modern commercial banking system. They are trying to gradually cut the percentage of the non-performing loans in their total loans from about 25% to no more than 15% in 2005 as required by the central bank. This task is very arduous. The stock of non-performing loans is huge, and there are non-performing loans newly increased for various reasons, so it will take long time to dispose them by traditional methods alone such as clearing, recovering and transforming them. Securitizing non-performing loans is of great significance because it helps putting assets to use again and developing new areas of asset and profit increase, thus promoting and guaranteeing the fulfillment of the plan for lowering the percentage of non-performing loans in total bank loans ^[2].

2.2 Securitizing Non-performing Loans Is an Important Part of Efforts to Improve the System for Disposing the Non-performing Loans of the State-owned Commercial Banks in China

The past practice of China's state-owned commercial banks shows that it is highly inefficient to dispose non-performing loans by recovering, transforming, auctioning in a unified way or clearing them, of which the result is also very bad. More effective methods are urgently needed. However, China has never resorted to asset securitization, a new creative financial method that has been widely used abroad to dispose the non-performing loans. Securitizing the non-performing loans helps putting non-performing loans into use again, disposing loans more efficiently, raising the recovery rate of assets and diffusing risks. Therefore, introducing the method of securitizing non-performing loans is of great significance for China to develop the ways of disposing non-performing loans, improve the system for disposing of these loans, and establish a market-based mechanism for disposing them.

2.3 Securitization of Non-performing Loans Helps Avoiding the Open Losses in Disposing Assets, and It Is Easy to Be Carried out

Using the existing methods to turn the invisible loss as a result of the discount of the securitized non-performing loans of state-owned commercial banks into open loss exerts too great influences over the current financial conditions of these banks for them to take. In disposing non-performing loans by securitizing them, we can select an appropriate pattern to keep these loans within the framework of the balance sheet. This makes it easier to control the negative influence over the current financial conditions of commercial banks ^[3].

More important, the securitization of non-performing loans in China is more practical than foreign commercial banks' securitization of the high-quality assets such as housing mortgage loans.

Firstly, the current problem facing by the state-owned commercial banks in China is not a lack of asset liquidity or capital, but a lack of qualified targets of loan. For example, several banks in China jointly formulated

in 2002 the housing loans contract including collecting a fee on advance repayment. This reflects that with savings deposits increasing steadily, commercial banks have difficulties in investing them. Plus the current restrictions on investment of commercial banks and the lack of financial tools to choose from, the capital raised from securitizing high-quality assets can hardly be put into more effective use.

Secondly, there will be some costs in securitizing assets to improve their liquidity. The cost of raising capital by securitizing assets is generally higher than the cost of other savings deposits of banks. Due to the interest rate control in China, the interest margin will be inevitably narrowed. Therefore, before interest rates are liberalized, it is unnecessary for commercial banks to securitize high-quality assets.

3. Tentative Ideas for Securitizing Non-performing Loans of China's State-owned Commercial Banks

3.1 Principles for Securitizing Non-performing Loans

(1) The international and marketing-oriented principle. The prerequisites for securitizing non-performing loans are a developed, standard asset securities market, good laws and regulations, and high-quality intermediary service agencies and investors. But all these are not available in China now. Therefore, non-performing loans should be securitized in accordance with market practices by drawing foreign experience and cooperating with famous international intermediaries.

(2) The principle of observing laws and regulations. As laws and regulations have to be improved in China, non-performing loans should be securitized by fully considering the restrictions by current laws and regulations, the central bank's regulatory requirements, financial systems, and the management policies for foreign debt and foreign exchange. Everything should be done in accordance with laws and regulations. If the issuance is to be done in a foreign country, that country's relevant laws and regulations should be followed.

(3) The principle corresponding with the financial capacity and repayment capacity of commercial banks. In securitizing non-performing loans, if assets are valued beyond the financial capacity of commercial banks, then the job could be hardly done. In designing the size of the issue of non-performing loan securities, the way to issue them, their prices and their transaction, the repayment capacity of commercial banks must be taken into full consideration. All this must be done steadily, and corresponding adjustments must be made in accordance with the increase in the profit and capital of commercial banks.

3.2 In Securitizing Non-performing Loans, "Bankruptcy Remote" Can Be Achieved by Two Models: The Real Sale Model and the Trust Model. Within the Current Framework of Chinese Laws, The Trust Model May Be a Better Choice in Securitizing Non-performing Loans

(1) "Bankruptcy remote" is the separation of fundamental assets from the bankruptcy of founders and SPVs. That is, in case of the bankruptcy of founders and SPVs, securitized assets will not be used for bankruptcy repayment as bankruptcy assets so as to safeguard the interests of asset securities investors.^[4]

The bankruptcy remote mechanism for securitizing assets is formed by establishing SPVs. Generally speaking, SPVs are in the forms of SPCs and trust agencies. Accordingly, in securitizing assets, two models can be used to achieve bankruptcy remote—the real sale model and the trust model.

—SPCs are subsidiaries founders, especially set up for securitizing assets. In the model of real sale, founders transfer fundamental assets to them completely and really. And then SPCs issue asset-backed securities to investors. The capital raised will serve as the valuable consideration for purchasing the securitized assets of founders.

—Founders may choose to designate the securitized fundamental assets as special types of trust property and on the strength of independence of trust property, achieve risk separation of securitized fundamental assets from other assets of the principals and the possessed assets of the agents. Neither the principals nor the agents of bankruptcy will affect the trust property held by the agents. This way keeps the fundamental assets within the balance sheet of founders.

(2) The international practice at present is to establish SPCs. The laws of different countries often have many regulations on the establishment of SPCs to make them the carriers and channels of the structural financing in securitizing assets to achieve the “real sale” between founders and SPCs. KAMCO, a company that leads Asia in securitizing assets to dispose of non-performing loans, uses this method.

(3) Due to the lack of relevant support laws and regulations in China, it is not feasible for the country to establish SPCs to securitize assets, as it will have too many legal barriers to overcome. Moreover, if the SPC model is used to achieve “real sale” in the process of securitizing non-performing loans, the losses for pricing non-performing loans of commercial banks will be shifted from invisible losses to open losses. This is more than the financial resources of Chinese commercial banks can tolerate.

(4) China promulgated the Trust Law in 2001, which makes it possible to securitize non-performing loans. According to Article 15 of the law, “Trust property is different from the other property for which the principal has not established trust. After establishing trust, when the principal is disbanded or abolished in accordance with the law or declared bankrupt, and if the principal is the only beneficiary, the trust shall end and the trust property shall be regarded as legacy or liquidation assets. If the principal is not the only beneficiary, the trust shall be renewed and the trust property shall not be regarded as legacy or liquidation assets. However, when the principal, a co-beneficiary is disbanded or abolished in accordance with the law or declared bankrupt, his/her trust beneficiary right shall be regarded as legacy or liquidation assets.” According to Article 16, “Trust property is different from the property owned by the principal and shall not be incorporated into the inherent property of the principal or become property of his/her inherent property. When the principal is disbanded or abolished in accordance with the law or declared bankrupt, the trust property shall not be regarded as legacy or liquidation assets.” Therefore, commercial banks can place non-performing loans under the trust of trust agencies to achieve the “bankruptcy remote” of fundamental assets and the “bankruptcy remote” needed to securitize non-performing loans^[5].

3.3 Fundamental Assets: In Determining the Establishment of Pooling, Consideration Should Be Given to Non-performing Loans that Can Produce Relatively Expected Cash Flows or Have a Relatively High Cashability

At present, the credit awareness and debt repayment ability of debtors of non-performing loans in China are not optimistic. It is impossible to expect their cash flows by relying only on the debt repayment schedule as agreed in the loan contract or the debt restructuring agreement. Assets should be evaluated, and cash flows should be predicted mainly in accordance with the cash flows resulting from the cashing of disposed hypothecated property. Therefore, the pooling for securitization should consist of assets in kind or loan assets backed by assets in kind such as real estate collateral loans. Consideration should also be given to securitizing such non-performing loans as overdue infrastructure loans that have relatively stable cash flows so as to make it easier for the successful issue of securities and lay a solid foundation for further securitization.

4. Problems to Be Solved for Securitizing Non-Performing Loans

4.1 Legislation and Other Basic Work Should Be Strengthened

At the three stages of asset initiation, establishing special carriers and determining financial structures for securitizing non-performing loans, corresponding and even special laws and regulations are needed. The rights and obligations of the market players involved at the stages must also be defined in accordance with the corresponding laws. In order to ensure the eventual securitization of non-performing assets, work should be done now to establish a framework of laws and regulations for securitizing non-performing loans in light of the Chinese conditions as well as international practices, including, for example, market access and exit, business scope, business items, market behavior rules, service targets, financial regulation, risk control, responsibilities and rights of regulatory bodies. Specific and clearly defined regulations should be formulated for accounting standards, taxation and the treatment of overseas financing.

4.2 The Government Needs to Provide the Necessary Policy Support

In order that securitizing the non-performing loans serves the long-term economic development in China, the government must actively promote and fully support this effort and establish an efficient, standard and safe market system and transaction rules to attract Chinese and foreign investors. For example, the government could start off with giving tax exemptions on the returns from investment in non-performing loan-backed securities; set up credit guarantee agencies on its own or support the establishment of such agencies to provide credit guarantee for non-performing loan-backed securities.

4.3 The Systems of Asset Evaluation and Due Diligence Should Be Further Standardized

In terms of quantities alone, China already has many credit evaluation agencies at present, but it has few authoritative and internationally influential due diligence agencies. Therefore, it is necessary to standardize the act of asset evaluation agencies, establish a perfect asset evaluation standard system, and adopt internationally accepted due diligence methods. At the same time, it is essential to increase the cooperation between domestic and international famous due diligence agencies, set up joint due diligence companies, and improve the overall technical level of Chinese due diligence agencies.

4.4 Institutional Investors for Non-performing Loans Should Be Developed

At the initial stage of securitizing non-performing loans, China will lack a necessary contingent of investors. It could issue non-performing loan-back securities in selected countries and regions that have a developed market for securitizing non-performing loans. But in the long run, it is necessary to quickly develop China's domestic market for securitizing non-performing loans. The practice in developed countries shows that the main investors of non-performing loans are institutional investors. Without institutional investors, it is difficult to securitize non-performing loans. It is, therefore, necessary to appropriately adjust certain policies and regulations, establish funds for securitizing non-performing loans, and gradually open the market for securitizing non-performing loans to insurance funds, pension funds, foreign investors and other institutional investors.

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