

Non-Performing Loan Securitization in the People's Republic of China¹

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ABSTRACT

Chinese authorities have initiated disposal methods ranging from loans sales to debt-for-equity swaps to resolve the country's Non-Performing Loans (NPL). NPL securitization, a form of structured finance, tops the list of innovative financing techniques to resolve the remaining USD\$73.1 billion² of the original USD\$170 billion removed from the banking system by Asset Management Companies (AMC), which were formed specifically to handle NPL disposal. With increased securitization activity within the Asia-Pacific, this paper seeks to determine if the People's Republic of China's (PRC) legal and economic underpinnings are conducive for a broad implementation of NPL securitization. This paper finds that government participation must persist through ongoing policy adjustments, and debt restructuring schemes must be initiated before securitization structures can accommodate the continuing NPL disposal effort and elicit sustained investor interest.

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“Vigorous efforts should be made to turn NPLs into securities, i.e. to issue bonds in the capital market for financing with the support of expected cash flow generated by the assets. This serves as one of the methods with best effect in asset preservation and loss reduction for the AMCs to treat NPLs to achieve quick asset realization and produce little negative social effect. In the light of the reality of China’s AMCs, we will create conditions to choose some assets from the NPLs with expected cash flow in a certain period, which will be used as mortgage for bond issuing, with the stress on the issuing of real estate mortgage loan securities and equity mortgage securities in the case of debt-equity swap. By turning the assets into securities, and by utilizing the funds raised through bond issuing, we can make better use of the real estate loans and enliven the production and operation of enterprises undergoing the transformation of creditor’s right to equity right, thereby promoting the internal value of NPLs.”

**- Wang Xin-Yi, President
& CEO of China Cinda
Asset Management
Corporation**

I. INTRODUCTION

In the early 1980s, securitization was principally an American financing technique. Since then, securitization, or at least the desire to employ it, has spread to other countries seeking to advance their financing frontiers. In the Asia-Pacific region, securitization of bank loans, mortgages and other liabilities have been steadfastly developing. The potential for securitization exists in the PRC given the stages of policy progression, government assistance, and the inauguration of institutions aimed specifically at addressing the NPL issue.

Though NPL securitization is not a modern or innovative idea, it could function well within the PRC's budding legal and economic framework. Securitization consists mainly of asset differentiation and trust usage, which rely on risk diversification, cash flow packaging techniques, and collateralization. When these key principles are properly enforced in a country's NPL securitization, they enable analysts to gauge the level of that country's financial maturity. A country's ability to incorporate commercial and foreign interest to bypass the normally complicated bureaucratic procedures ultimately serves as a barometer of that country's success in promoting securitization.

There are a number of ways to resolve unsustainable corporate debt of the State-Owned Enterprises (SOE) through methods of corporate restructuring, i.e., discontinuing less profitable or loss-making non-core segments of the business, cutting excess labor, or seeking cost reductions to increase the company's earnings capacity and improve operating margins. More drastic steps include government involvement in closing and liquidating the firm with the aide of state organs, or the pursuit of Mergers & Acquisitions opportunities with a financially viable and suitable peer. These techniques

have maximized the cash recovery rates of NPLs, but they need to be aggregated under the umbrella of securitization to reach full potential.

A financial vehicle's value is reflected through its ability to maximize asset value, which in the PRC context is equivalent to maximizing NPL value. The restructuring of the corporate and financial sectors hinges primarily on a company's flow of cash in keeping its debt afloat, and securitizing a company's debt in conjunction with adequate liquidation of its existing assets can liberate cash values remaining in distressed NPLs.

A robust implementation of securitization must demonstrate pragmatic applicability and theoretical resilience. Based on these two criteria, this paper offers prudent modifications to existing securitization frameworks in order to enhance investor interest and generate larger demand for NPL-securitized products. The theoretical arguments will center on:

- The gradual and certain evolution in Chinese policy reforms towards a quasi-liberal market approach warrants securitization as a feasible model for NPL disposal.
- Regime willingness to formulate a crucial base to support the movement.
- Securitization in its varied forms fits within the nascent legal and economic landscapes.
- Empirical knowledge from the U.S., Japan and Korea securitization experiences provide precedents for a more adaptive, comprehensive securitization.
- Traditional financing techniques are no longer offering satisfactory returns.

I will also argue that securitization is the best-suited strategy from the following applied standpoints:

- Legislative reforms in the areas of mortgage and security laws provide the essential references for true asset sales and the creation of offshore special purpose vehicles.

- Other methods of NPL disposal have either plateaued or become ineffective, such as asset sales and debt-for-equity swaps.
- The maturing relationship between trust usage and cash flow management in NPL securitization benefits from increased experimentation.

This paper will first examine the original U.S. development of the mortgage-loan securitization technique, and the corresponding roles of government institutions in solidifying the foundation and fostering the growth of the securitization mechanism. The focus then turns to critical factors in Japan and Korea that prompted their adoption of the U.S. securitization model. Ultimately, a variety of factors will be explored, culminating in a draft of a securitization structure that addresses investor concerns by incorporating best-of-breed designs that function within the PRC economic and legal landscape.

Securitization Background

Securitization is the process of converting loans or receivables into negotiable instruments. It enables non-tradable assets that range in marketability, credit-worthiness, and size to become liquid secondary instruments through repackaging, bearing credit enhancements, and cash flow structuring. Securitization facilitates the separation of different risk and reward expectations, broadens the investor base, and allows loans to be more efficiently priced and allocated to a greater range of investors. Securitization can structure a stream of cash flow from financial assets, usually in the form of receivables, and deliver the assets to the investor.

Securitization boosts the size of secondary mortgage markets, which in turn encourages more mortgage originations. Through loan sales, benefits are achieved for banking institutions that act as loan originators. Many have shown the empirical benefits

of loan sales via securitization, and the salutary effects it has on the availability of banking capital. Greenbaum and Thakor (1987) demonstrated that the signaling of information regarding loan quality may be enhanced when loans are sold rather than funded by deposits. James (1987) demonstrates that loan sales can provide lower cost financing for bank equity-holders and enable the bank to avoid a possible underinvestment problem when it has risky debt outstanding.

There are two forms of securitized products: the Asset-Backed Securities (ABS) and Mortgage-Backed Securities (MBS). They are similar in structure, but collateralized by different underlying assets. An ABS securitizes cash collateral, such as credit card receivables, auto loans, home equity credit lines, student loans -- essentially any asset with a cash stream. An MBS predominantly securitizes immobile objects such as real estate, commercial buildings, and residential homes.

MBS are structured on a stream of cash payments from mortgage loans extended by an originator (i.e., a bank) to a receiver (i.e., a business or household). By linking the wholesale and retail credit markets, this form of securitization handles receivables and loans from financial institutions, and removes the credit risks associated with the assets. By freeing up the illiquid assets (i.e., exchanging mortgage payments from an apartment complex owner for readily available lump-sum cash), the originator of the MBS can enjoy lower interest rates than through traditional, and often impractical, methods of issuing debt or equity. By removing credit risk and interest rate risk from the originators of wholesale mortgage loans and redirecting this risk onto the secondary market, it allows originators to focus on their prime lending businesses and release more capital for increased liquidity. The securitized system also enables credit rating agencies to rate the

qualities of the originator and the securitized products separately, preventing the originators' ratings from possibly causing a negative influence on the sovereign ratings of the assets being packaged.

Securitization is not without its flaws. In addition to interest-rate risk and credit risk, prepayment risks exist and are major concerns for investors on the secondary level. Moral hazard and asymmetric information problems on the part of originators also weigh on investors. The moral hazard problem exists with originators of mortgage loans who retain no necessary interest or incentive to ensure the quality of the loan or the behavior of the borrowers. As a result the risk of default on the underlying assets increases, pushing up interest rates and posing troublesome conditions to existing investors (Duesenberry 1987). Pennacchi (1988) tackled the moral hazard problem by coming up with a model where banks may improve the returns on loans by monitoring borrowers, effectively allowing the banks to make loans less expensively through securitization by avoiding costs associated with required reserves and capital requirements. In addition, Flannery (1994) showed how current bank-examination procedures may induce banks to hold only certain risk classes of loans, while profitably selling the rest.

Securitization and the PRC

Given that most State-Owned Enterprises (SOE) hold assets such as buildings and machinery with opaque cash streams but retain significant value under the current real estate conditions, the analysis of NPL securitization hinges primarily on the development of a robust MBS market.

Securitization of mortgage loans forms the basis of a strong secondary mortgage market -- a feature of financial progress for most developed nations. Though many countries and regions have embraced the MBS, the procedure is not practiced in the PRC. Complications over land ownership, property subsidies, and a plethora of other conflicting policies promulgated by the Communist regime has historically stymied the development of privatized housing and the cultivation of an MBS-friendly environment in the PRC.

In an effort to discard socialist doctrines, the Chinese government has demonstrated willingness to reform housing policy. With the de-collectivization of land ownership in the 1980s, the 1992 movement towards private residential ownership, and the 1995 establishment of a Housing Fund targeted at housing subsidies for low-to-middle income workers (the majority of Chinese workers), the regime has shed some of its socialistic approaches to governance. Moreover, with a new policy integrating housing benefits as a part of total worker cash compensation in 1998, the PRC ended subsidized housing and cleared the last ostensible hurdle to making the country receptive to mortgage securitization.

II. COUNTRY PERSPECTIVES

With regional differences and varying economic modalities between the U.S. and Asian countries, it should be expected that the practice of NPL resolutions would also deviate between these nations. In charting out the securitization methods utilized by the U.S., Japan and Korea, the findings that follow surprisingly show that the methods are largely the same. In resolving the NPLs held by Savings & Loan (S&L) institutions, the U.S. approach is closely emulated by the other countries examined with respect to their need to rescue failing banking institutions through utilizing a reinvigorated form of finance.

The enhancements unique to each country tend to become apparent through juxtaposing the similarities and differences across securitization systems. Although the securitization techniques in Japan and Korea are largely derived from the U.S. model of securitization, they have evolved over the years to incorporate each country's respective legal framework and economic climate. China, which has only recently begun using mortgages, stands to benefit greatly through the infusion of best-of-breed methods imported from countries that have prior securitization experiences. Japan and Korea's rationale for modeling themselves after the U.S. justifies examining China under the same securitization lenses.

The U.S. Experience

The critical component of successful mortgages and mortgage-related activities is the creation of the secondary mortgage market, and federal institutions and agencies are

integral to the outcomes of initiative. The US government established the Federal Housing Administration (FHA) in the 1930s to insure residential mortgage loans made to lower income Americans against default. The importance of the FHA was more pronounced after the real estate collapse in the 1930s, after which many mortgage loans defaulted. The Veterans Administration (VA) established a similar program that guaranteed mortgage loans made to home purchasers who had served in the US military. With the formation of the Federal National Mortgage Association, or Fannie Mae, in 1938 to buy and sell mortgage loans insured by the FHA, the government created a mechanism to transfer surplus capital to areas deficient in necessary housing funds. The scheme involved Fannie Mae issuing corporate debt to fund their purchase of loans from originators, thus boosting the lenders' capacity to make new loans while concurrently connecting U.S. housing finance and wholesale capital markets. In 1968, the secondary mortgage market was solidified when Fannie Mae was split into two; Fannie Mae was privatized and worked on market-quoted loans, while another entity was created to explicitly carry out MBS functions for the government housing programs known as the Government National Mortgage Association (Ginnie Mae). With Fannie Mae providing a base for mortgage loans, Ginnie Mae encouraged the development of the secondary market for FHA or VA-insured mortgages and issued the first U.S. MBS in 1970 for investment purposes.

The Federal Home Loan Mortgage Corporation, or Freddie Mac, was formed in 1970 to provide the same securitization of mortgages except with a broader mandate to service conventional mortgages outside of FHA or VA- jurisdictions. Freddie Mac also accelerated the development of the secondary market. Investment banks assisted in the

secondary market by facilitating the MBS underwriting and distributing processes where commercial banks could not participate. These institutions and agencies were crucial in forming the backbone of the securitization structure. Their actual practices provide a framework for further augmenting the securitization technique outside of the U.S.

During the S&L crisis, the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) rescued nearly 3000 banks which failed or became insolvent. The FDIC, which focused on rescuing bank deposits, and the RTC, which was mandated to support thrifts in the role of the conservator,³ securitized real estate properties collateralized from inherited portfolios of distressed assets.

Methods used by the RTC to dispose of failed institutions' assets included auctions, equity partnerships, and the use of asset management contractors, but securitization was the single most distinctive asset disposition technique used by the RTC in its successful handling of NPLs. Securitization was instrumental in disposing the mortgage loans held in distressed savings and loan institutions (thrifts). These loans are deemed lost and unrecoverable as determined by principal and/or interest payments not paid by stipulated deadlines. Thrifts are often run by "Mom and Pop" owners based regionally to make loans to a neighboring constituency. They operate by receiving short-term retail deposits and making long-term loans at higher rates. After interest rate ceilings were lifted in the late 1980s, thrifts had the incentive to overextend loans at higher interest rates to generate more business, which caused many bankruptcies and insolvencies as the yield curve flattened. Between 1980 and 1994, 1617 federally insured banks with \$302.6 billion in assets were closed while 1295 savings and loan institutions

³ Conservators acquired the assets of failing thrifts, handled all processes relating to the securitization and disposition of illiquid assets in order to recover a maximum percentage of bad loans.

with \$621 billion in assets were either closed or received government support (FDIC 4). During the same period, nearly 500,000 loans were packaged for securitization, ranging from home mortgages, commercial mortgages and manufactured housing loans to leases and installment contracts on personal property (FDIC 61).

The Japanese Experience

In contrast to the timely, drastic actions initiated by U.S. banks to reduce NPLs with the help of government assistance, Japanese banks paid little attention to the issue of remnant NPLs from previous aggressive campaigns. Consequently, the quality of Japanese banking assets deteriorated and the international capital markets have levered premiums on inter-bank loans with Japanese financial institutions.

Asset sales have resulted in significant cash recoveries in Japanese NPL transactions, there securitization has not appealed until recently as the favored financing method. While securitization is a valuable option, straight asset sales had proven to be largely successful. In a study conducted on bankruptcy proceedings, Kroszner and Rotner (1994) showed that in the case of Japanese asset sales, investors favor liquidation in bankruptcy procedures. While sales of Japanese real estate in a July 1991 Dallas auction returned 21 percent of book value, post-liquidation in the October 1992 Dallas auction sold for 62 percent of book value. Loans in the May 1992 San Antonio auction sold for 19 percent of book value, while post-liquidation loans in August 1992 San Antonio auction sold for 36 percent of book value.

Even as bankruptcy proceedings help raise the value of distressed assets, the Japanese financial system remains obstructed by the estimated USD\$1.3 trillion NPL

problem in 2003 from receiving credibility through any NPL recovery scheme. The first attempt at building a domestic NPL disposal program occurred in 1998, when the Japanese government enacted laws to use public funds to expedite NPL removal by purchasing preferred stock in Japanese banks as a de facto capital injection.

The creation of the Resolution and Collection Corporation (RCC), a government institution with a mandate to purchase NPLs from Japanese banks, has largely paralleled the U.S. RTC initiative. The RCC was established as a full subsidiary of the Deposit Insurance Corporation of Japan (DICJ) through the merger of the Housing Loan Administration Corporation and the Resolution Collection Bank in 1998.⁴ On the DICJ website, the RCC is mandated to:

- Recover loans transferred from Jusen⁵.
- Collect NPLs from failed financial institutions.
- Collect NPLs from sound financial institutions.
- Subscribe shares to enhance capital adequacy of financial institutions.

While the RTC unconditionally rescued banks in all conditions, not all Japanese banks were candidates for rescue. In contrast to the U.S, even though recapitalization was inevitable in both countries, Ito believes that to let all banks survive through securitization via subsidies and capital infusions would be a mistake (Ito, 2002)

Herr and Miyazaki (1999) suggest that in the RCC's plan to resolve the banks' NPLs, securitization is a way to look beyond differentiating banks by financial health. Instead, aggregating their assets into pools and issuing certificates through a tiered

⁴ HLAC was established in July 1996 to collect the non-performing loans related to Jusen companies as a 100% subsidiary of DICJ (capitalization Y200 billion). RCB was established in September 1996 to be prompted the disposal and management of non-performing loans transferred from failed credit cooperatives as a 75% subsidiary of the DICJ (capitalization of Y120 billion for the DICJ).

securitization method is the most efficient way to ease the NPL problems in Japan. Ito (2002) indirectly supports the idea, pointing out that while the purchase of bad loans by RCC at subsidized prices can stop systematic risk through capital injection, selectively eliminating banks from rescue hinders the market-driven rehabilitary processes via negative signaling. In response, the RCC included and utilized to great extent securitization procedures as part of its portfolio of NPL disposal tools to expedite the rescue process.⁶

Herr and Miyazaki (1999) propose a system of securitization that utilizes a mixing of performing and non-performing loans to achieve a desirable risk profile of bundled loans to be sold to a special purpose vehicle, which would in turn raise the cash from issuing asset-backed securities. The most attractive aspect of this financing technique is rooted in the benefits from tax rules, which is better than writing off the loans outright.

Herr and Miyazaki's scheme operates primarily with real estate collateralized loans and is not without its problems. In this scheme, the bank creates a SPV structure. The bank determines the book value of the collateral at market price and sells it to the SPV at a discounted price while achieving immediate tax benefits by reporting the discounted portion of the asset as a tax loss. The SPV then issues ABS to raise capital, and the proceeds from the continued operation and/or sale of the real estate properties would serve as collateral or as cash flow. The risk profile of the bank would improve significantly as the NPLs are removed from the banks' balance sheet. The sale of the loans to the SPV, backed by selectively diversified risks characteristics of a pool of

⁵ Jusen is the Housing Loan Corporation, a non-government entity.

⁶ Three deals – Y21 bn in 1999, Y31 billion in 2000, and Y100 billion in 2003 have been priced or mandated by the RCC using securitization methods to dispose NPLs via foreign banks(Goldman Sachs and Morgan Stanley) arrangements.

properties, can secure positive credit ratings for the securities issued by the SPV, while the bank can increase liquidity for further loans and capital creation.

The driving force behind securitization has mainly been legal considerations. The 1998 repeal of the Susshi-ho law, which prevented non-bank finance companies from securing loans, increased demand for securitization. In addition, a special purpose vehicle (SPV) Law passed in March 1998 facilitated securitization by reducing the capital requirement and lowering corporation tax by fifty percent. Prior to that change, the MITI Law of 1993 allowed lease receivables, credit card receivables, receivables under installment sales contracts, and auto receivables to qualify for small-lot claim issues to investors as asset-backed securities. These laws have been instrumental in facilitating the formation of onshore special purpose vehicles for securitization. For banks in the real estate sector seeking to reduce distressed assets held by debtors, securitization is also considered to be an attractive option. In March 1997, bank regulators passed twelve measures including SPV capital reduction, tax exemptions, trust structure usage and classification of trust certificates as securities in a boost to facilitating securitization in the sector (Butt 33-34).

Methods in dealing with Japanese NPLs have turned to securitization to setup structures, and have led to innovative trust usage under accommodating legal initiatives. With the erection of the RCC, the Japanese have essentially instated critical domestic pillars to support the building securitization framework that has largely followed the RTC.

The Korean Experience

The Korean NPL experience resembles many of its regional peers in identification, resolution and collection procedures. Activity in the securitization field picked up after Korea implemented numerous regulatory laws over mortgages and their uses in securitization transactions. The Asset Backed Securitization Law adopted in 1998 prescribing the provisions “required for establishment and operation of a mortgage-backed securitization company and issuance of mortgage-backed credit-secured bonds and mortgage-backed securities to extend the base of housing finance through long-term and stable supply of housing fund.” Accompanied by the Mortgage-Backed Securitization Company Act in 1999, both Acts stress separating the functions of securitization and mortgage management. The Acts are similar in that they requiring true sales of assets, and detail the provisions necessary to structure, issue, supervise and document mortgage-backed securities as well as outline a general framework for a regulatory environment to the fledging MBS market.

To provide a further boost to the securitization market, the Ministry of Finance and Economy revised the current ABS law to remove some remaining regulatory hurdles for issuers and investors. Most importantly, the scope of eligible issuers was expanded to include financial institutions, commercial and industrial banks, licensed financial institutions, merchant banks, insurance companies, securities companies, and trust companies.

The Korea Mortgage Corporation (KoMoCo), whose function is similar to the U.S. Freddie Mac and Ginnie Mae, spearheads a significant government initiative to

setup a mortgage-securitization body. As Korea's first specialized secondary home mortgage market entity, it is mandated to issue MBS collateralized by mortgage loans acquired from the National Housing Fund.

KomoCo elevates public support and solidifies the government's role in facilitating the MBS procedure. Government support has been empirically shown to appeal to investors of all risk appetites, since KoMoCo on average only issues 3.8 percent of the total notional MBS amount as subordinated securities for credit enhancement, while non-bank mortgage lenders need to secure 16.3 percent as enhancement (Lee, 2003).

Korea Asset Management Corporation (KAMCO), an agency of the government set up to deal with the acquisition, management and disposition of NPLs, reflects in many ways a culmination of the country's experimentation and trial-by-error resourcefulness. Its mandates include

- Management and operation of NPA Fund
- Acquisition and resolution of NPLs
- Workout of distressed companies
- Management and sales of state-owned properties and confiscated properties.

KAMCO has also modeled much of its practices from the RTC experience, with the government actively providing resources and oversight. KAMCO is able to maximize returns on bad loans and ensure speedy resolution in the deployment of resolution strategies. KAMCO's success lies in solicitation of foreign interest in the NPLs, which was initiated by a landmark international bidding in 1998 where ABS was issued to joint ventures through open sales (Oh, 2002). The first ABS backed by NPLs was issued in

July 2000, when a US\$395 million ABS was issued under the joint lead management of Deutsche Bank and UBS Warburg. This transaction proved the international marketability of the Korean NPLs and demonstrated foreign interest and confidence in KAMCO's ability to provide quality NPLs for investment purposes.

Landmark KAMCO Transaction⁷

One particular case study identifies the success of South Korea's reformed financial laws in attracting capital to real-estate backed NPLs via SPV structures. In November 2000, KAMCO completed the first international securitization of NPLs by a Korean government agency. In the Morgan Stanley Realty-led transaction, a portfolio of distressed loans and properties worth 174.94 billion Won were purchased from KAMCO (Davies 2001). Through the use of the "Resurgence Korea One SPV", it marked the first time an international real estate fund has gone to the Korean capital markets. For this transaction, the fund purchased the underlying asset pool of loans and properties from KAMCO and resold them to the SPV, which issued the bonds in three tranches of 4-year maturities rated AAA at a coupon rate of 5.57% to several investment trusts, AMCs, and life insurance companies seeking the higher yield.⁸ According to Ho Yang, managing director of the securitized products group at Morgan Stanley Korea, investors looked at the cash flow associated with the SPV and realized it is one with high credit quality and little risk. It also has higher yields than they would find with other transactions.

⁷ Refer to Appendix A for the fund flow in this deal.

LEARNING FROM THE U.S., JAPAN AND KOREA EXPERIENCES

Time and practical experiences have added to the intricacies of NPL securitization since the U.S. first applied it during the Savings & Loan crisis. While the U.S. provides the template for applying NPL securitization, Japanese and Korean initiatives include innovative strategies that make securitization more focused in order to address particular objectives. The Japanese authorities explored and liberalized legal provisions in the structuring of securitization to introduce SPVs, while Korea utilized derivatives embedded in the cash flow structuring between the banks and KAMCO to introduce a more sophisticated, tailor-made securitization involving offshore SPVs. The U.S. RTC, Japanese RCC and the Korean KAMCO all share similarities in structure and mandates. They are all assisted by government organs that serve related functions (i.e., Freddie Mac and KoMoCo). The conception of the KoMoCo suggests that the supporting scaffold linking primary and secondary mortgage markets is a necessity in order to normalize the transition to securitization in a sustainable manner.

⁸ According to figures published by the Korean Securities Dealers Association, the deal represents a pickup of 76bps over 3-year treasuries and below the 5-year yield of 5.74%.

III. PRC SECURITIZATION LANDSCAPE

It would be incomplete to analyze the effects of securitization without looking at the classification of lenders in the PRC to identify the beneficiaries who stand to gain from a higher volume of NPL liquidation via securitization.

Lenders in the PRC are commercial banks, policy banks, foreign banks invested in the PRC, and at the grass-root level urban credit cooperatives and rural credit cooperatives. Four major state-owned banks have historically formed the bulk of the lending to SOEs. The Agricultural Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB) and the Industrial and Commercial Bank of China (ICBC) each dedicate services to particular industries and sectors. ABC specializes in loans to the agricultural sector, BOC in foreign exchange loans and international trade finance, CCB in capital construction and fixed assets loans, and ICBC in working capital loans to the industrial and commercial sectors. Loans were made in accordance with credit quotas and priorities established in each region. While such quotas were removed on working capital loans with indicative planning,⁹ massive loans have been allocated to favored regions and industries at the expense of the lenders.

On the practical level, the lenders lack the ability to impose financial discipline on SOE borrowers. The lending process therefore fails to satisfy moral hazard and

⁹ Credit quotas were removed on January 1 1998 in the *Notice on Improving the Administration of the Scale of Loans by State-owned Commercial Banks*.

asymmetric information criteria, and domestic financial institutions are reluctant to advance credit or rollover existing loans to government agencies and enterprises.

Restructuring

The reforms undertaken to rectify NPL debt is a two-tiered effort. On the one hand, the central government has embarked on physical SOE reform, offering radical changes to the Maoist legacy system and increasing room for market forces to resolve NPLs. Meanwhile, financial sector reform is predominantly shaping up in the form of restructuring the bank-firm relationship, most importantly the history of debt accumulation that is now becoming the center of reform attention. While any academic article exploring such a co-dependent relationship must undoubtedly discuss SOE history and its problems to provide the precursor for discussing the problem, the focus should primarily be centered on the state banks and the reforms undertaken to improve this sector. Without concomitant reforms to cure SOE inefficiencies and institute discriminate systems to avoid bank loans to defaulting borrowers, no number of adjustments will yield effective returns to the AMC proceedings.

China's four big commercial banks are overstaffed and undercapitalized, and there historically has been no competition to infuse best practices into the operating cultures. The NPL problem accumulated partially from state-based directional lending that stemmed from political and social considerations, through which success was measured by loan volumes (Harris, OECD 2002).

The People's Bank of China (PBOC) has taken a variety of measures to restructure domestic financial institutions. For example, in October 1996, the Everbright Trust and Investment Company could not meet its maturing debts. To avoid its bankruptcy, the PBOC decided to convert its debts of about 5 billion Renminbi (RMB)

into equity. However, the company hardly earned any profits during the next three years, and creditors suffered great losses from this kind of financial conversion (Xie 125). In 1997, 28 local urban credit cooperatives in Hainan province suffered runs. Instead of closing the cooperatives, in December 1997 the Hainan Development Bank was ordered by authorities to take over the cooperatives. The result was further deterioration of the bank's situation, despite a credit line of 3 billion RMB of assistance from the PBOC. In January 1998, Hainan Development Bank was finally closed (Xie 125-126).

The corporate restructuring effort at both the SOEs and the state-owned banks can be characterized by gross inefficiency and the delaying of important steps to restore credibility and ensure prompt NPL disposition. The major cause for the two institutional failures was the lack of clear policy directive. Opting for administrative decree rather than legal resolution, the regime has shown its weakness in stipulating restructuring techniques. The only solution offered in the Commercial Law stipulates that the PBOC may take over the bank in an acquisition.¹⁰ By contrast, the FDIC clearly requires US authorities to restructure a problem bank through open bank assistance and purchase in the form of taking asset or securities and assuming liabilities, including capital infusion. In purchase and assumption transactions, the FDIC purchases assets and assumes liabilities of the failed institution.

To select a location to begin restructuring and re-capitalizing efforts, securitization ought to be first carried out in regions near more industrialized cities and coastal areas, where domestic and foreign capital are abundant. NPLs also tend to be more transparent and supported by clearer underlying assets in the coastal areas, where most of the bad loans are still collateralized partially by usable factory land and

machinery that were once geared for export-oriented production. Foreign financial groups will find this aspect of reform more attractive, and will therefore participate through minority shareholding in these companies without fear of corruption once the balance books have been cleared up.

Asset Management Companies

The success of the RTC in the United States rested primarily on the speed with which NPL assets were brought to market and securitized. The creation of sovereign entities for special handling of the S&L crisis was also important. The Chinese government has emulated this strategy closely through the swift formation of Asset Management Companies (AMC), as well as employing RTC's former chairman L. William Seidman to advise the government and guide the program.¹¹ AMCs in the PRC are not only tasked to remove NPLs from the banks, but also mandated to act as an enforcer to prevent future NPLs from accumulating as well as find realistic ways to recover cash value from the removed NPLs. As such, only when AMCs utilize securitization on a broad scale can securitization take root as a premier tool for NPL workout.

The main purposes for utilizing the AMC structure can be summarized as follows:

- To protect the franchise and stability of the originating bank from runs and adverse publicity.
- To directly improve the banks' profitability and clean up the balance sheets.
- To centralize debts under one creditor to simplify negotiation and recovery procedures

¹⁰ Commercial Banking Law, article 64.

¹¹ This is admitted by China's Premier Zhu Rongji. See associate Press Newswires, 'Clintoni Zhu text By the Associated Press'(April 9, 1999).

- To bypass bureaucratic red-tape and expedite collection through more drastic actions.
- To allow selective NPL packaging in open auctions to optimize disposal.

Through these entities, the Chinese government has ensured that the first steps toward successful mortgage securitization can proceed efficiently with the correct transfer and handling of bad loans from the state-owned banks. The regime has made drastic attempts to extract liquidity and capital from bad loans secured by real-estate collateral. In a swift move to re-capitalize the four major state banks, the government implemented AMC's in the spring of 1999 to deal directly with NPL collection, realization, and disposition. In this effort to re-capitalize the four large state commercial banks and to improve the incentive to collect outstanding loans, the government has transferred nearly 1.4 trillion RMB of state-owned assets to four AMC's. Each of the four AMC's (Orient, Cinda, Huarong, Great Wall) mirror one of the four largest state-owned banks (BOC, CCB, ICBC, and ABC, respectively), deploying debt-for-equity swapping techniques with only their corresponding bank's NPL portfolios.

Over the last four years, the AMC's have matured in dealing with distressed assets.

This is evident in three aspects of the AMC's current operations:

- 1) The practice of distressed assets value maximization. The directors of the AMC's are aware of the meaning behind asset management and disposition. To achieve the objective, the rate of asset return is maximized while servicing and management costs are minimized. Identifying the "bad apples" and disposing them first, with attention on improving the healthier assets for sale at the opportune moment, enables the managers to fully realize the concept of cash recovery through any means necessary.
- 2) Operating under legal and political measures designed to benefit NPL disposal. The central regime provides AMC's with favorable taxation(the same applies to foreign parties engaged in dealings with the AMC's), interest and administrative

fees. Meanwhile, the courts have improved support, i.e., reduced legal costs and imposed stricter punishment on debtors.

3) Increasing acceptance of schemes such as securitization.

Since AMC's are the sole entities to realize NPL value, the inherent lack of value-added initiatives in the AMC business model is alarming. The call for securitization aims to address that concern. For AMC's, using MBS and ABS to raise funds make sense because it fits the nature of their mandate to seek new capital for added liquidity to resolve the NPL transferred from the state banks. To financial institutions, securitization is appealing because it liberates assets from their balance sheets.

The Chinese government's modeling of the RTC by forming AMC's demonstrates China's desire to modernize and emulate U.S. techniques and practices, but more importantly China's consideration of securitization reveals an even more aggressive stance. As the AMC's slowly phase out outdated traditions in favor of securitization-oriented financing techniques, implementing securitization will enable a well-adjusted departure from the current disposal mechanisms.

Direct Asset Sales

While broader, more comprehensive reform solutions exist beyond AMC implementation, one other option that was utilized was the sale of NPL portfolios directly to foreign creditors without passing through the AMC medium. This course of action mandates that foreign investors must establish a corporate entity in China in the form of a foreign-invested enterprise to be able to hold a business license, receive RMB revenues, and convert RMB into foreign currency. There would need to be dealings directly between the four main state banks and interested foreign parties through foreign-capital

driven fund-management and brokerage companies, as this practice was the only way to ensure the convertibility of the RMB. However, as this course of action means partially relinquishing the central bureaucracy's control over economic affairs, policies were erected to curb foreign participation. Foreign investments in fund-management companies are capped at 49 percent and 33 percent for brokerages.

The enforcement of the closed capital market ensures that no clean exit scenarios exist for foreign investors, such as the conversion of the purchased RMB debt to a foreign exchange and remitting the funds out of the country. Therefore, foreigners must be physically present and established in China to maneuver the funds, yet restrictions limit their freedom of operation. Visibly, the optimal Chinese policy is aimed at fostering and retaining foreign participation in resolving the NPLs problem, but only grants foreign parties limited autonomy. This method of direct contact between banks and foreign parties does not resonate with the party's optimal policy.

Debt-for-Equity Swaps

The debt-for-equity process involves AMC's taking shares of equity in the pre-selected SOEs, and these equities are funded by AMC-issued and Ministry of Finance guaranteed bonds that will deduct NPLs from the banks' balance sheets. Among the 601 enterprises recommended to the AMC, 508 decided to carry out debt-for-equity swaps. By the end of 2001, State Council had approved 483 enterprises to carry out debt-equity swaps amounting to 294 billion RMB.

Debt-for-equity swaps are the first step in a series of radical reforms to liquidate the NPLs, opening the doors to more creative measures for the AMC to gradually evolve

towards utilizing mortgage securitization. Although debt-for-equity swaps have produced optimistic recovery rates for the AMCs on their NPLs portfolios (32.5% for Huarong, 24% for Great Wall, 35.1% for Cinda),¹² the process has plateaued due to recent measures designed to prevent the stock market from overheating.

Many critics have suggested that the current structure of debt-to-equity swap with AMCs is inefficient, since the PBOC bears the haircut by extending the capital in the form of zero-coupon bonds to purchase the NPLs from the state-owned banks (see Harris 2002, McNally 2002). In reality, the NPL problem has simply been relocated from one debtor to another, and can be described as an intra-state money-go-around. In addition, debt-for-equity swaps do not allow AMCs to exercise their right as shareholder to participate in the day-to-day management of enterprises that underwent debt-for-equity swaps, leaving the governance issue unaddressed. Since debt-for-equity swaps require 90 percent of SOEs to buyback all the stock equity within 5-7 years (Wang 2000), enterprises and governments should emphasize the optimization of assets, expansion of capital, and long-term benefits to form a plan with the creditors. As such, the debt-for-equity strategy is not the preferred choice among small-to-medium SOEs.

Finally, most debt/equity swaps that have reasonable chances of recovery have already been explored. Yang Kaisheng, President and CEO of Huarong AMC, acknowledged that in the current Huarong portfolio all existing NPLs that qualify for debt/equity swaps have been realized and recovered. Realizing that debt-for-equity swaps have exhausted its value, AMCs are now beginning to look at other methods of

¹² David G. Pierce, "China's Bank Asset Management Companies: Gold in Them Thar Hills?", O'Melveny & Myers LLP, July 2001.

NPL disposal in anticipation of more resourceful financing technique such as securitization.

IV. Privatization of Property & Credit Restructuring

While the AMCs have proven instrumental in disposing NPLs, and their operations have been commendable in focusing on NPL elimination, other indirect factors are also essential factors to securitization. As real estate appreciates in price and the demand for property surges, the increase in housing ownership provides firm support to the pervasive nature of mortgage loans. When primary mortgage markets develop through standardized systems that match mortgage supply and demand, secondary mortgage markets are bound to follow in laying the foundation for securitization of mortgage loans.

From 1998 to 2002, the average growth rate of investment in China's real estate industry was around 20 percent. During the first half of this year, the total investment in the same sector was 381.7 billion RMB, a surge of 34 percent over the same period of last year.¹³ Meanwhile, in the first six months of this year, the loans provided by banks across the country totaled 1.8 trillion RMB, nearly the total for the whole of last year, of which a great part flowed into the real estate industry.

The privatization of real estate ownership in China has proven to be significant in limiting the abstract valuation of property prices, and concurrently improving the market's assessment of real estate pricing. As a result of the pickup in ownership, a new

¹³ China checks to prevent overheating. <http://chinablwg.lehmanlaw.com/2003/08/26.html>

middle class of consumers will provide impetus to the emerging mortgage loan market as more individuals develop the capacity to purchase their own homes.

As property ownership picks up in China, the mortgage platform for MBS will strengthen in value as more private owners translate into more mortgage borrowers. Real-estate investment since 1999 has increased from slightly over 30 billion RMB to more than 55 billion RMB by the end of 2002 (Dolven 2003). With an increasing valuation of real estate in China, a MBS market will benefit from an appreciation in collateral prices.

The success of mortgaging China's developing real estate depends on several factors. With commercialized residential properties becoming more common than the previously centrally-allocated apartments, many provinces such as Zhejiang, Jiangsu, and Guangdong have privatized more than 70 percent of their housing.¹⁴ Cities such as Tianjin and Kunming in Yunnan want to accelerate the process by banning state enterprises from buying and building housing. In 1993, the government allocated more than half of the total residential housing. In 2001, almost 70percent of private housing came from open market purchases.¹⁵ Growing demand and more exacting requirements from individual house buyers have compelled developers to build better quality residential properties, which lengthen the average duration of household ownership and helps to stabilize the maturity of mortgage payments.

Redirection of Credit & The Emerging Middle-Segment Consumer

¹⁴ CLSA Emerging Markets Data, published 2003.

¹⁵ Ibid.

An ailing credit system with low loan recovery rates makes securitization increasingly difficult in providing protection for investors and their ownership in the stream of mortgage receivables. Therefore, to address this problem, the government initiated growth in the form of infrastructural enhancements, administrative enterprises, and other large-scale operations leading to a boom in the construction industry, subsequently creating a nascent middle-class segment of workers and citizens, providing a huge potential base for a middle-class-driven mortgage market.¹⁶

Capitalize on the opportunity to make reliable loans and reduce their exposure to bad loans, the banks should shift policy to extend loans to credible individuals capable of repayment instead of lending to SOEs. The middle class is a critical component in building China's MBS market. Currently, less than one percent of bank loans are to individuals and private companies (Dolven 2003). As a result of this change, consumer defaults have fallen from 8.5 percent of total lending in 1Q03 to 8.1 percent in 2Q03 (Dolven 2002). It is valuable to extend loans to individuals for the purpose of mortgaging the purchases of automobiles or homes, which accounts for seventeen percent of all new bank loans. At an estimated two percent default rate, lending to a better pool of borrowers works to the advantage of the banks in establishing a credible base of systematic and reliable mortgage payments. While China's small and mid-sized private enterprises account for nearly fifty percent of the country's \$1.3 trillion GDP, they only receive 10-15 percent of China's total commercial loans (Baglolle 2003). In the first half of 2003, according to the China Banking Regulatory Commission, the NPL totaled 2.54

¹⁶ "MBS yun yong zhong de zhao yun fong xian feng xi he zhe du".
<http://www.chinasecuritization.com/2002111213>.

trillion RMB with the NPL ratio at 19.6 percent of total loans.¹⁷ Optimistically, the dropping NPL ratio is due to the larger percentage of loans to the middle-class consumers.

With the PBOC loosening the central bank's control over loans for personal purposes, such as education loans, consumer durables, and tourism, accompanied by a rise in consumer protection in the early 1990s through the creation of the China Consumers Association, the regime is accountable for rebuilding a systematically dependent debt-lending system (White 172). In turn, this restructuring of credit should ensure that future loans will be appropriately distributed to middle-class consumers, who will likely spearhead the primary mortgage development to encourage financial institutions to exercise more prevalent uses of mortgage securitization.

¹⁷ "China's Banking Sector Sees Declining Non-Performing Loans". People's Daily. August 08, 2003.

V. SECURITIZATION SCHEME

With the focus turned on recoverable SOE assets and disposable NPLs from cities and coastal areas where restructuring and recapitalizing efforts have turned out favorable results, NPL securitization and structured finance have increased their appeal as alternative solutions. Wang Xin-yi, President & CEO of China Cinda Asset Management Corporation, stated at a recent Asia Pacific NPL forum that securitization should be pursued as a immediate course of action to satisfy NPL disposal. His view reflects the fact that Cinda operates as the sole NPL disposer for the China Construction Bank, which holds collateral from real estate loans in the form of prime residential sites that are conducive to mortgage securitization. Most of the NPLs are collateralized with assets held in the shape of factories and factory land all across China's coastline (Slater 2001). The Bank also currently holds fifty percent of the country's home loans and as of April had a mortgage portfolio of \$12 billion.¹⁸ In a major step towards the mortgage securitization efforts, Cinda has announced the sale of 10.8 billion RMB worth of NPLs to an international consortium led by investment bank Morgan Stanley. Meanwhile,

Australian firm Macquarie Securitization has worked for two years on a deal to securitize the NPLs of the CCB to capitalize on the attractive nature of the NPL collaterals.

Other AMC executives have demonstrated the same inclination toward securitization as a feasible apparatus. According to a July 2003 issue of the Financial Times, the CEO of Huarong AMC, Yang Kaisheng, voiced out his favorable opinions on practicing securitization as a more sophisticated financial instrument for resolving NPLs. According to Yang, using securitization will attract more foreign investors with financial strength, since a majority of the domestic banks will not provide financing for investments in NPLs. Stating his concerns over the lack of established rules and regulations governing the novel technique, Yang believes difficulties in pricing the sophisticated secondary market tools must be overcome by focusing on transparency in procedure, innovation in method, and maximization in return. Huarong's secret to success has derived largely from structuring and packaging the asset packages according to the investors' individual tastes. As such, securitization can also selectively include assets with different loan structures and geographical locations for diversifying bundled NPL risk.

Foreign investors seeking to participate in the securitization are faced with several dilemmas. The following sections offer suggestions to pinpoint each problematic area of investing in NPLs, and prescribe potential solutions to resolve each concern:

- 1) Differentiation of asset quality. Investors are unfamiliar with the business practices of the SOEs, and misguided by SOE management who possess insider knowledge on performing vs. non-performing assets.
- 2) Uncertainty over legal concerns. The creation of SPVs and the underlying claim to the transferred assets are plagued by uncertainty over the true-sale nature of the collateral and the bankruptcy proceedings that might entail such transfers.

¹⁸ "China's used mortgages". Businessweek, May 29, 2000.

- 3) Stability of the cash flow. Investors are wary over the credit ratings of the SPV structures, and desire credit enhancements over the annuities.

To address each of these concerns, the following sections analyze experiences and existing techniques and frameworks to offer piecemeal solutions to ease each question.

1) Proposal for Asset Differentiation

The main approach for larger high-quality SOEs has been to convert their assets into equity to allow finance via the capital markets. In addition to qualifying as listed companies under international listing procedures, regulations stipulate that the state must hold the majority of shares in those listed companies, which restricts the SOEs from becoming true corporate entities (Tenev and Zhang, 2002). This level of government intervention is not desirable, especially if firms with negative net assets cannot qualify for bankruptcy proceedings.

If these SOEs have valuable assets, they should separate out their operating assets and setup a new legal entity. In salvaging the good slices of the apple from the whole, debt restructuring and asset cleaving can preserve the performing assets while disposing distressed assets. Through this act of differentiation, the asset quality of the MBS collateral becomes more transparent and its value is easier to assess.

The Changchun approach emerged from a field study by Wang Weiguo, who first suggested the scheme for debt restructuring in SOEs.¹⁹ The approach refers to the Changchun City experience of administratively cleaving off profitable, performing assets from old enterprises which were burdened with debts and run inefficiently with untrained

¹⁹ The Study was presented at an international consortium in Vancouver, B.C, entitled “Changchun Approach: A New Scheme for Debt Restructuring in China,” 2000.

workers, low quality assets and obsolete technology and equipment. However, among the fixed assets of the SOEs many were profitable and produced marketable good that were put aside since the SOEs were tied down in debt and lack of funding. In 1995, the city decided to formally cut the joint liability between the new enterprises and the old ones, as to rid the profitable assets of the former debts. This was against the law, but under mediation of the government the city was able to pioneer the first instances of this type of debt restructuring and set precedent for other SOEs.

Spun from the Changchun experience, the 1996 Purchase-Sale Restructuring(PSR) was originally a localized method for debt restructuring. It can now be used to facilitate transactions that separate healthy assets from poor assets in lieu of a national securitization effort. The procedure sets up a state-owned company to receive the profitable assets, and utilizes the healthy assets to produce a stream of income to repay the loan extended by the funding source. This procedure can precede the securitization effort, paving the way to completing the final asset transfer to the SPVs.

At the end of 1999, Changchun had 65 SOEs revived from 79 distressed ones. In August 2000, there were 12 SOEs more that were revived. Among all the revived, 35 were restructured through this approach (Wang 2000). All shared common features; in each case, the restructuring enterprise has been long buried in difficulties as a whole, but parts exhibited vitality were profitable. The government invested capital and land use rights to setup a solely state-owned company, and the restructuring company, the new entity and the creditor (often the local lender) that holds 2/3 of existing liabilities negotiate to reach a comprehensive package of agreements to facilitate the transfer of profitable assets through debt restructuring.

Distressed enterprises and distressed assets are two sides of the same coin. Since most distressed enterprises under the PSR method possess performing assets that need to be separated, the banks must seek reinvigorated energy and capital to partner with the enterprises, instead of trying to seize any available asset. The bank's participations can be observed in a case study involving the Changchun Printing Machinery Plant. The Plant was a mid-scale enterprise and the largest printing machinery manufacturer in the province. Insolvent loans from the late 1980s invested in technical innovations led to a 4.65 million RMB loss. In 1998, the municipal government invested 500,000 RMB in cash and 10 million RMB in land use rights to establish a new company named Changchun Printing Machinery Company Limited. As a result of multiple negotiations the major creditor, Changchun Branch of the China Industrial and Commercial Bank, lent 24.28 million RMB to the company, which was able to purchase 39.39 million RMB worth of assets at book value. The Bank cleared up 43.6 percent of its total claim on the old SOE, and the profitable assets are continuing to pay off the rest. Two other cases including the Changchun Car-Lamp Factory and Oil Factory yielded similar results, with investments from foreign companies and some enterprises ending up providing value-added intermediary services.

According to Wang, the Banks that extend additional capital through the Changchun process can secure their claim by mortgaging upon the assigned assets and properties. For creditors who have prior claim on the assigned assets through previous mortgages, there is no chance for the smaller creditors to access the asset. Even in bankruptcy proceedings, a secured creditor has the priority of using the collateral to satisfy his claim first. Therefore, the secured creditor can allow his debtor to transfer the

collateral to someone else and receive remuneration with the revenue received (Reinbach 1998). Wang believes that as a matter of practice, almost all the insolvent SOEs have had their key assets become subject to major creditors' security rights.

Secured Project Financing Involving Mortgages

In certain types of secured lending transactions, obtaining a mortgage over a borrower's fixed assets and equipment offers the best form of collateral security. Particularly in the case of real estate development projects, lenders typically require a mortgage over the development as security for their loans. In the context of more infrastructure development projects, a mortgage of this nature serves a defensive purpose. While mortgagees can effectively take control over such projects, the collateral do not offer much realizable value or security if they consist of assets such as power plants and other illiquid and produce commodities difficult to liquidate and impossible to operate.

Apart from land use rights and real-estate, the most commonly mortgaged items and most pertinent to the NPL discussion are machinery and equipment owned by a project company. The equipment of SOEs can be listed and confirmed for collateralization purposes in securing project loans. Historically, virtually all PRC enterprises undergoing a workout have surplus assets that are not fundamental to the operations of the business(Shi, 2002). According to Shi, ownership in non-core assets that do not generate revenue to the company's core operations should be liquidated, and the proceeds used to repay the short-term funds used to purchase such assets.

Wang also expresses that it is a very common situation in the PRC that a production line of an insolvent SOE is very hard to be sold out in piecemeal and most of

the time smaller creditors and the court are unable to find buyers to purchase it whole. There is usually great difficulty in unloading the equipment and other assets of the SOE to repay the loans. Subsequently, the appeal of the Changchun approach rests on the performance of the profitable assets, since the book value of the assets in most cases would not be worth the net discounted value of the cash flow they generate in the long term horizon. More pertinently, since the SOE assets are often insolvent, their liquidation through bankruptcy procedures become extremely important and must be stipulated by some form of mortgage law prior to any securitization undertakings that will generate sufficient investor demand for the NPL securitized products.

2) Legal Issues

While the PRC does not yet have any specific legislation to regulate securitization techniques, the building blocks to such legislature can be found in indirect legislature reforms that implicitly facilitate the process. With laws regarding mortgages and rights to securities gradually developing, the legal framework is currently in a significantly better position to support asset securitization than it was just a few years ago. There have been substantial changes to the laws and regulations regarding financial transactions and the creation and enforcement of security in the PRC, particularly governing mortgage securitization on the local and regional levels.

For a considerable period of time, at both the national and provincial levels, the Chinese regime has welcomed asset securitization financing. Despite the absence of national laws over this time period, the Vice-President of the State Development Bank of China has been advocating asset securitization to not only fund China's massive

infrastructural projects, but also for provinces to independently forge ahead with securitizing residential mortgages.²⁰ Such initiatives have compensated for national policy inadequacies by adopting local mortgage laws.

While the U.S. distilled its current legal model for mortgage securitization through decades of experimentation and scrutiny, China may have great difficulty in adopting the U.S. model of centralized agency support for the various functional needs of mortgage securitization. As China continues to modernize its legal system, important bankruptcy, insolvency and private ownership laws are still not in place as they exist in the U.S. Given its sheer size, China cannot be counted on to legally facilitate securitization techniques as quickly as demonstrated by other neighboring nations.

Contract Law

To address these concerns, the government has begun to experiment with some of the financial and legal infrastructures that facilitate securitized transactions involving the transfer of mortgage payments. This is essential to an efficient MBS market since the bulk of the transactions involve the pass-through treatment of cash flows. The Contract Law, which became effective on October 1, 1999, symbolizes an important change to the Chinese legal system on this regard.

The Transfer of Receivables

Because any securitization will rely heavily on how the cash flow from the debtor will be accounted for by the creditor, it is important to regulate the transfer of receivables in the transaction. Since most asset securitizations will create an SPV, which will issue

²⁰ “Bank Sees ABS as New Finance Tool”. China Daily. March 3, 1998.

securities to foreign investors, the AMCs have to count on there being normative legislature guaranteeing that cash can be passed from the SOE debtors onto third parties.

The Contract Law makes possible a structured approach in dealing with the transfer of receivables to third parties, and outlines the conditions allowing a creditor to assign its rights under a contract to a third party provided that the creditor has notified the relevant debtor of such assignment and the rights are assignable (Kruger 2000). In addition, Article 79-81 stipulate that in certain instances, receivables constitute part of the property of an enterprise, so an enterprise can transfer receivables as under a normal commercial transaction. The transfer of receivables under the Contract Law is therefore allowed, although depending on the type of receivables the consent of relevant approval authorities might be required.

Bankruptcy Proceedings

Securitization structures rely on bankruptcy remoteness, which severs the liability from the issuer and places it on the investor. Specifically, it is important to cleave the assets from the originators' balance sheets. However, this raises problems since mortgage loans are one of the most valuable assets to the banks. The default rate on mortgages is the lowest for mass-loan products by mainland banks: less than 0.5 percent last year compared with the overall 30 percent default rate of NPLs. When the relationship between the originator and the servicer is legally vague, the servicer can elect to discontinue the securitization flows. This poses a threat to the beneficial nature of securitization to turn illiquid assets into safe, predictable investment vehicles with a cash stream.

The bankruptcy laws in China operate in a manner similar to those in the U.S., which is comforting to investor sentiment. Upon petition for bankruptcy, the law requires the debtor to submit a plan of reorganization upon creditor and court approval. The SOE has up to two years to complete the reorganization, which can be terminated sooner by the court in the event of deteriorating financial situations. The creditor has rights to protected collateral, and mortgages of all forms of property are permissible under China's Securities Law. The smooth functioning of this aspect of bankruptcy allows the creditors, who are potentially the investors of an MBS, to pursue the liquidation and validation of their investment in the event of a bankruptcy.

To ensure that in the event of a bankruptcy the "true sales" of the assets to an SPV is legitimate, there must be measures to prevent the originator from legally retaining ownership to the assets. The issuer, as a separate entity, retains the beneficial interest and manages the securitization's pooling and servicing operations. The issuer usually creates a SPV which is a conservator of the physical assets. In a true sale, the assets are fully delivered to the SPV and off the books of the originator. In pass-through sales, the issuer receives the pool of receivables, enhances their marketability and sells them to investors while not retaining legal interest over the collateralized assets.

Securities Law²¹

Transfers of legal title to mortgages poses a considerable practical difficulty. In order to transfer land rights from the SOE to trust structures as an essential part of NPL securitization, laws such as the Securities Law have been erected to deal with the entirely new concept of the sale of mortgage loans as securities in the PRC.

Especially in the use of special purpose vehicles, in some cases the transfer of assets under local trust laws is more beneficially performed with offshore vehicles. The securitization financing relies on the separation of the assets from the originator, including bankruptcy insulation, true sale, and other considerations that were difficult to work through before the law came into effect.

The importance of this law is reflected in the liquidation procedures related to securitization. The Securities Law provides guidelines in its seven-chapter, ninety-six-article layout which contains multiple provisions governing which asset classes can qualify as collateral to a mortgage transaction. The importance of mortgages as a form of security is underlined by the fact that many provinces and municipalities in the PRC have their own local real property mortgage regulations, many of them actively encouraged by the central government to pursue these regulations independently even before the promulgation of the Securities Law, which has almost one-third of its provisions related to mortgages.

In the bankruptcy proceedings, the Securities Law stipulates the conditions and the procedures over which assets can be auctioned off and liquidated for cash. This serves as a condition of the securitization structure, which permit interested parties to structure and package past and existing NPLs backed by the appropriate collateral that qualify under the Securities Law into bundles for sale to SPVs.

The drafting of the Securities Law signals the advent of a new form of debt financing in the PRC. While this process is far from complete, the Securities Law lays the foundation for further developments in the area of facilitating lawful financing transactions. For foreign institutions looking to enter transactions involving PRC-based

²¹ See Appendix B for a detailed listing of relevant guidelines.

securities, the advent of this skeletal framework allows a clear assessment of the PRC's effort in regulating this growing segment of the economy.

Enforcing Mortgage Collection Under the Securities Law

The articles provide an important link to interpreting the enforcement of performing the servicing of obligation from the mortgagor to the mortgagee. In Article 47, it states that mortgaged property can be seized by a People's Court due to the debtor's failure to maintain the contractual obligation, and the mortgagee can from the date of seize be entitled to the proceeds realized upon the sale of seized property. Even more clearly stated, in part four of Article 53, a mortgagee who has not received full payment at the expiration of the term for performance of the obligation may agree to receive payment with the mortgagor by converting the mortgaged property into value or by obtaining proceeds from the auction or sale of the property. The mortgagee is entitled to receive from the date of seizure all natural rights(for example, crops from the land) and legal rights(for example rental fees) generated by the mortgaged property. As enforcement measures to protect the value of the mortgaged property, the mortgagee may request the mortgagor to cease and desist all conduct that is attributed to the change in value of the property in question. As the mortgage provisions clarify what was once lacking in the banks' loans to SOEs, the provisions can now act as terms of enforcement for the collection of assets given the failure of the borrower to pay any amount due under the loan document.

3) SPV Credit Enhancement

The ability to obtain a reliable credit rating for securities backed by NPLs is a vital component of securitization in developed markets. While no credit rating agency would have an easy time assessing the risks of the NPLs held by the AMCs, some form of credit enhancement through both internal and external collateralization is nonetheless necessary to give investors a sense of security. The placement of securitized products with investors generally requires giving adequate protection against risk of default to eliminate the need for them to monitor the collateral directly, which in practice would be difficult for NPL-backed issuances.

Inspired by the Brady Bond program, which are bonds issued by emerging market countries backed by U.S. Treasuries, the PRC can use its foreign reserves held in the form of U.S. Treasuries as credit enhancement for the securities issued by AMCs to onshore or offshore SPVs. Named for former U.S. Treasury Secretary Nicholas Brady, the program enabled banks to swap defaulted commercial bank loans into new bonds in an effort to restructuring emerging market debt instruments. Countries involved in the Brady Bond program purchase U.S. Treasury zero-coupon bonds as collateral, effectively insuring investors of at least their principal investment from default risk.

Only China has demonstrated the ability to match the notional amount of the NPLs with its holding of Treasuries as guarantee. For decades, the Chinese government has purchased significant amounts of U.S. Treasuries, putting in \$51.8 billion in 2001 into U.S. Treasuries, corporate bonds and commercial paper, contrasted with a figure of only \$15.5 billion in 2000 (Belfour 2002). As of May 2003, the Chinese government holds \$121.7 billion worth of US treasuries, the second largest global position and a formidable amount that provides substantial credibility to be used as collateral and credit

enhancement for the national securitization effort. The restricted convertibility of the RMB makes collateral in the form of US Treasuries more attractive and liquid for reverting capital.

Multi-Class Offering

Attributing to the cost and difficulty of obtaining credit enhancements, a form of internal credit enhancement notwithstanding over-collateralization, or reserve funds such as U.S. Treasuries, is the use of subordinated structures. For complications involving debt restructuring or partitioning of assets, multiple tranches of securities should be issued to reflect the existing credit risk of the underlying pool of SOE assets. Since the AMC's are mandated to dispose of NPL portfolios by realizing maximum value, the relatively illiquid participants in direct loan sales stifle optimal NPL recovery. By marketing the best assets first, the cash recovery rate will most likely dissipate as the quality of the assets deteriorate with follow-on auctions (Bottelier 2003). A recent example was an auction involving Huarong AMC.²² These examples demonstrate that direct asset sales no longer equate to the maximized cash recovery.

By issuing securities from the SPV in tranches, the issuer can pursue investors with different levels of risk appetite. Dividing securities backed by NPL collaterals into tranches with different risk characteristics and its own pay-out schedule, such as using senior to subordinated notes, enables investors with the least exposure to risk in the

senior class o benefit from first claim on the higher quality NPLs in the event of liquidation.

Other Governmental Actions and Proposed Solutions

The government can take several policy initiatives to both expedite and safeguard the MBS procedure. First, by maintaining its inflationary targets and interest rates the government can project a predictable yield curve and phase in greater interest rate flexibility. This is important to let the market make adjustments on inflationary expectations and allow the market to calculate commercial rates accordingly. In this manner, interest rates will not surprise mortgage borrowers and force them to refinance in short periods, which can be a challenge to investors attracted to the steady and long-term cash stream from MBS instruments. Following this, enacting a penalty for early redemption on mortgage loans can further assuage investors. Although such a plan may not work in the long run, for a nascent MBS market it will help to reduce uncertainties.

Secondly, the government must formalize its policy for recovering collateral through court enforcement. Historically the government has recovered NPLs against collateral negligently, but this needs improvement as collateral depreciates in value over time and continually lose book value as the collection procedures drag on. The government must proactively execute collateral retrieval from insolvent institutions and establish a systematic court procedure to streamline dispute resolution. In addition, the government can also modify its policy of seizing property with regard to eminent domain; as long as a market with user rights exists, the government must be clear and

²² An international auction in 2001 generated limited success, however a later international auction held in 2003 attracted fewer buyers and offers resulted in cash recovery rates less than half of those received in the

precise about making exceptions to the rule²³ whenever it whimsically seizes housing or deconstructs housing units to fit national objectives.

While Chinese construction market will see another 1.05 trillion RMB in new properties over each decade, the ultimate question rests on if the government will ever release land ownership from state ownership. With Zhu Ronji's enforcement of housing reforms in 1998 that turned over vast amounts of state-owned housing to people at discounts of up to 80 percent (Berthelson 2003), it is another worry for investors who cannot clearly discern who the property ownership belongs to; the resident or the government? While the state does not allow private property ownership, land-use rights can last up to 70 years. But ownership and right-to-use extract different implied values from a mortgage loan. The solution to this dilemma requires the regime to sacrifice control over centralized land ownership, which will be a difficult task. However, if a skeletal structure can be erected with reference to any of the aforementioned suggestions, much can be accomplished in moving the securitization efforts forward.

2001 auction.

VI. CONCLUDING REMARKS

In lieu of a junk pile of assets and real estate painfully reminiscent of an irresponsible era of corporate lending, the Chinese central regime has decided in recent years to incorporate western financial innovations and relaxed key policies and provided critical provisions in an effort to redeem the lost assets. With securitization appearing robust in regional experiences, the assets and real estate from the SOEs present viable scenarios for the central regime to make monumental changes in freeing NPLs .

The focus of this paper has been to narrow the NPL securitization discussion to PRC loans based on real-estate, buildings and other classifiable land assets. With the inflow of foreign capital and commercial/investment bank participation, concepts based on the financial tools of asset-backed securitization, in particular the practical validity and functionalities of utilizing mortgage-backed securitization, need corresponding investor interest to take root in the PRC. Subsequently, strengthening key components of

²³ The government has been known to reacquire rights to land for public use as part of “centralized planning”.

securitization allows both domestic and foreign capital easier access to investment in NPLs.

This paper, however, has not analyzed the value of statistical and numerical efficiencies with choosing between economic alternatives. While debt-for-equity and asset sales no longer work principally as means of NPL disposal, the empirical gains from securitizing NPLs and incorporating international participation have not been the primary focus of study here. In earnest, the disclosure rules for banks and institutions involved on the deals release little to no public information, and data collection for this study can only be incomplete and misleading. As a case in point, while the objective 4.17% annual return from the Huarong-Citic Trust deal provides a relative measurement to comparative yields of government treasuries and corporate debt, this figure doesn't bring to the table any worthwhile discoveries.²⁴ Since NPL securitization deals continue to develop in a scope that reserves the disclosure of information to only those involved in the transactions, this paper cannot incorporate practical or empirical proof of the stage of securitization development. Therefore, it has focused on the multiple facets in the construction of the securitization vehicles through which most transactions are realized.

Once a sustainable model of securitization can stand its ground in the PRC, it will surely draw foreign investor interest. However, this paper has not commented on other motivations that might compel investors to seek Chinese assets. One particular reason under heated debate is the Chinese regime's willingness to revalue the strength of the RMB as an international currency.²⁵ Since a controversial Goldman Sachs research report published in mid-July of 2003, many analysts have questioned if the potential

²⁴ Refer to Appendix C for the structure of the deal.

²⁵ From a discussion with Russell Cummer, a former derivatives researcher at Merrill Lynch in Hong Kong.

appreciation in the RMB with respect to the U.S. Dollar is a better justification for speculating on PRC assets than the actual belief that there is more transparency and improved fundamentals in how Chinese SOEs are managed. As such, this reason obscures the true incentives governing foreign investor participation in asset sales, debt-for-equity restructuring and most importantly, existing and future securitization transactions.

Nonetheless, disregarding unclear buy-side enthusiasms, the Chinese regime has demonstrated receptiveness to securitization techniques as alternative funding sources for Chinese companies and financial institutions. The series of policies and actions modeling the U.S. RTC demonstrates the regime's willingness to assimilate Westernized securitization efforts in clearing NPLs, but this process must be performed with discretionary authority and under suitable circumstances. While the NPL problem may provide the necessary impetus to overcome the complex web of regulatory constraints and legal impediments surrounding mortgage securitization, uncertainties still inherent in the key areas of Chinese law will mean that investors, originators, arrangers and credit enhancers will have to be willing to display moderate tolerance and flexibility in acknowledging the future flow of securitization deals in China. Fortunately to all concerned parties, there is visible initiative from the government to allow actionable policy adjustments on an ongoing basis.

As mortgage-related practices improve, the accommodating legal and regulatory changes will still require a mid- to long-term commitment on the part of both the government and the investors. The deals that follow will be modeled on imperfect structures, as they always are in developing markets, but undoubtedly refinements will

ensure that, in the long-run, a standard model can be suitable for sustained usage in securitization deals in the PRC. Only at that point when the most ideal enhancements and careful thoughts are put into practice will foreign investors be comfortable with the risk perceptions associated with securitization in the PRC.

VII. APPENDIX A

First KAMCO NPL Securitization

As a demonstration of government and private collaboration, the KAMCO transaction utilized the ABS law and carried out satisfactory results under the approval of the Financial Supervisory Commission of Korea (FSC).

The transaction involved the establishment of two SPVs, one in Korea and the other in the Cayman Islands. KAMCO sold a static portfolio of NPLs (denominated in US dollars and Japanese Yen) to the Korean SPV. The Korean SPV then issued notes which were purchased by the Cayman SPV. The Cayman SPV in turn issued notes secured on the Korean SPV's notes and the NPLs.

A. The Korean SPV

The Korean SPV, Korea First International ABS Speciality Co., Ltd., was incorporated as an off-balance sheet limited liability company in accordance with the

Korean Act on Asset Backed Securitization of 1998. Under the Act, the Korean SPV may not engage in any business other than the securitization transaction itself and certain activities ancillary to such securitization. The shares of the Korean SPV are owned by its sole director and KAMCO. KAMCO, in its capacity as master servicer, was responsible for the management of the NPLs on behalf of the Korean SPV in accordance with the Act.

The Korean SPV issued senior and subordinated notes and used proceeds to purchase the NPLs. The security for the senior notes included a Korean law pledge over the NPLs. In addition to the subordinated notes, further credit enhancement for the senior notes was provided by way of an irrevocable credit facility from The Korean Development Bank to the Korean SPV for the total amount payable under the Korean SPV senior note.

B. Cayman SPV

The Korean SPV senior notes were purchased by the Cayman SPV, Korea Asset Funding 2000-1 Limited, which in turn issued floating rate notes. Those notes are secured on the Cayman SPV's interest in the Korean SPV senior note. The Cayman SPV senior notes were rated BBB+ by Fitch and Baa2 by Moody's. They are listed on the Luxembourg Stock Exchange. These notes were offered to qualified institutional buyers in the United States.

For reasons of Korean regulation, the terms of the senior note prohibit redemption of principal (either in whole or in part) until after the first anniversary of the issue date of the senior note.

C. True sale of NPLs

Each NPL is the subject of a settlement agreement made between KAMCO and the Korean commercial bank. Each settlement agreement contains an option which allows KAMCO to “put” an NPL back to the selling bank should certain events such as payment defaults continue for a long period of time.

The NPLs and the settlement agreements were transferred to the Korean SPV under a loan portfolio transfer agreement governed by Korean law. KAMCO, as master servicer, is responsible for exercising the put options with the Korean banks on behalf of the Korean SPV.

Under the Act, the transfer of the NPLs would constitute a true sale, rather than the creation of a security interest, only if:

- The transfer is by way of sale and purchase.
- The transferee has the right to profits in respect of the assets and the right to dispose of such assets.
- The transferor has no right to demand the return of the assets and the transferee has no right to repayment of the purchase price for the assets.
- The transferee assumes all of the risks associated with the assets, except that the transferor may provide certain warranties in respect of the assets.

Generally, borrowers must be notified and consent to NPLs transfers before KAMCO can transfer NPLs to foreign parties; otherwise, the NPLs are not enforceable against the borrowers. However, the Act stipulates that a notice of transfer is sufficient in lieu of actual debtor consent.

APPENDIX B

The Securities Law of the PRC(1995)

A mortgage as defined under the Securities Law, Article 33, can cover both immovable real property and personal property. Similarly under Article 34, properties that may be mortgaged are:

1. buildings and other attachments to land owned by the mortgagor;
2. machinery, transport equipment and other property owned by the mortgagor;
3. state-owned land use rights, premises and other attachments to land the mortgagor is legally entitled to dispose of;
4. state-owned machinery, transport equipment and other property the mortgagor is legally entitled to dispose of;

5. land use rights to barren hills, dry river beds, shoal and other unused lands which have been lawfully contracted for by the mortgagor, provided that the party which contracted out the same consents to the mortgage;
6. other property that may be mortgaged according to law.

However, properties prohibited from mortgage by Article 37 include²⁶

1. land ownership
2. leaseholds of collectively owned land such as cultivated land, omestead land, private plots, mountainous land, etc
3. educational facilities, medical and public health facilities and other public welfare facilities of institutions and social organizations for the public good such as schools, kindergartens, hospitals, etc
4. property of which the ownership of leaseholds are unclear or in dispute
5. property that has been sealed up, seized or subject to supervision and control according to law; and
6. other property that may not be mortgaged according to law.

²⁶ Article 37 subsection 1-6

APPENDIX C

Huarong – Citic Transaction

The Huarong-Citic Trust deal completed in June 2003 provides insight into the typical securitization setup. As expressed by the Huarong CEO Yang Kaisheng, while the project does not completely qualify as an asset securitization, it is undoubtedly an important step in the right direction.²⁷

The Huarong-Citic Trust deal was a 13.2 billion RMB, 3-year deal involving 256 creditors in 22 provinces. It was also the first time securitization was defended in lieu of extra expenses in its practice, with the RTC and KAMCO referenced as entities based on which Huarong modeled its transaction.²⁸

The deal relied heavily on the synergistic nature of securitization and trust usage. It employed strict asset separation between the AMC and the trust vehicle, as well as

²⁷ Asset Management Reference Summary, July 2003, Issue No. 13 based on Financial Times, September 12, 2003.

definitive identification of cash flow through a subordinated pass-through structure.

Huarong deposits the relevant assets into the receivership of Citic Trust, and Citic Trust organizes the trust and issues securities based on the Huarong assets in the trust structure (i.e. real estate, asset-backed NPLs, and other guaranteed assets). Huarong AMC receives the right of claim to the securities in its entirety, and investors can be entitled to share in those benefits through Huarong AMC, which possesses exclusive rights to the distribution of the securities for placement with institutional or retail accounts.

The concept advocates setting aside the assets to generate additional income, and expanding the variety of products available to investors. More importantly, isolation of assets through the trust usage allowed Huarong to dedicate the better portion of its asset-backed NPLs for securitization, effectively limiting investor risk exposure and gaining a higher credit rating for the project. The annual return for the primary, first-claim one billion RMB tranche is 4.17%, which up to July 9th, 2003 has been 80% sold.²⁹

²⁸ Ibid.

²⁹ Chinese Financial Broadcast, July 11, 2003.

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